Final Report

An Assessment And Rating Of The
POLISH BANKING SYSTEM

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USAID Objective 1.1 : Critical private markets expanded and strengthened
G/EGAD SSO 3: Support appropriate and functioning economic policies, market reforms, and institutions in emerging markets and priority cou**ntries**
G/EGAD SPO2: Enhance the ability of indigenous business to become viable within emerging markets.

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AN ASSESSMENT AND RATING OF THE POLISH BANKING SYSTEM

I. Introduction

The following assessment of the Polish banking system has been produced under contract to the United States Agency for International Development/Poland by KPMG Consulting, LLC and Michael Borish and Company, Inc. USAID conducted a similar assessment and rating of the banking system in 1998, utilizing the services of Michael Borish and Company, Inc. Thus, the 2000 assessment represents a comparative update of banking sector developments and related financial sector developments in Poland.

In addition to the banking sector assessment, a separate piece has been produced to review the contribution of USAID to banking and financial sector development in Poland since USAID's assistance efforts formally began in 1990. This provides a retrospective adjunct to the banking sector assessment, and points to specific areas of assistance that USAID may wish to consider following the closure of the Warsaw mission on July 31, 2000. (For the USAID-specific strategic piece, see "Post-Closure Assistance: Strategic Considerations for USAID in Financial Sector Development in the Transition States of Europe and Central Asia.")

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II. Methodology of the Rating System

The rating system utilized to assess the banking sector of Poland is based on a review of more than 200 issues and topics that have been used to construct a diagnostic methodology for the review of banking systems. This tool has been utilized by USAID in other parts of "transition Europe," and is applicable to virtually all banking sectors in the world. Countries where earlier assessments have been carried out include Bulgaria, Georgia, Hungary, Poland and Ukraine.

In its simplest form, the rating system is focused on four general areas of activity: financial sector infrastructure and institutions, economic factors and indicators, banking structure and system profile, and banking sector development based on prudential norms. These activities are then assessed based on 28 "sub-categories," and subject to five general classifications of ratings. The activities and sub-categories are included below.

USAID Banking Sector Rating System Activities	
General Areas of Activity	***Sub-Categories***
Financial Sector Infrastructure	• General policy and system • Legal framework • Regulatory and supervisory capacity • Payments systems • Accounting framework • Rating agencies • Financial media • Professional associations • Academic institutions • Miscellaneous areas relevant to financial sector infrastructure—telecommunications, postal, safekeeping
Economic Factors and Indicators	• General trends • Private sector development issues • Monetary and related savings and credit matters • Fiscal considerations • Exchange rates • Balance of payments issues
Banking Structure and System Profile	• Overview of the system and financial measures • Profile of ownership structures • Governance and management issues • Non-bank competition
Banking Sector Development Based on Prudential Norms	• Capital adequacy • Asset quality • Management capacity • Earnings • Liquidity • Operating environment • Transparency and disclosure • Sensitivity to market risks

The following classifications are utilized to provide a scoring for the individual issues assessed, as well as in developing a composite rating for the banking sector as a whole. Annex 1 provides greater descriptive detail about how the ratings apply by sub-category.

USAID Banking Sector Rating System Scoring Description	
5	Outstanding; world class; state-of-the-art; best practices; virtually no serious systemic risks
4	Solid; strong; satisfactory; competitive; few systemic risks or problems, and those are manageable
3	Adequate; favorable trend; improvement needed; potential for major systemic risks
2	Inadequate; weak; significant improvements needed; major potential for destabilization via systemic risks
1	Dismal; monopolist; resistant to competition and change; no confidence; widespread

	corruption; weak institutions

No effort has been made to weight individual variables, or to quantify ratings along mathematical lines. Rather, 28 major sub-categories of the four main groupings were all rated within the five-point rating system, with allowances for pluses and minuses in the event that the direct numerical classification did not fully match with performance. The evaluation is qualitative based on trends and assessments, and quantitative to the extent the figures are useful and meaningful. In general, the information available in Poland was sufficient to form a judgment on the banking sector. In fact, the availability of useful information is one of the positive developments evident in comparison with 1998. For instance, the major banks now have web sites that make quarterly and annual reports available, along with the specific institutions' views of economic issues that can affect institutional and market performance. Likewise, the National Bank of Poland (NBP) has an easy to use web site from which descriptive and analytical information is available. These sources are helpful in forming a judgment on the underlying direction of the banking sector. It should be noted as well that the 2000 assessment was delayed until mid-year to benefit from the availability of audited 1999 annual reports. In 1998, the assessment faced certain inconveniences associated with the timing of the exercise or the completeness of data[1]. While NBP reports do not provide institution-specific information, the additional information from the banks along with analysts' reports and other assessments present a fuller picture of banking sector trends in 2000 than was available in 1998. This trend also points to the general development and maturity of the banking sector in Poland, with improved management information systems and professionalism in the banks, obvious efforts made by NBP/GINB to coordinate its regulatory oversight role with Basle Committee (BIS) and other international and regional institutions to meet international standards, and a general requirement on the part of the market for more disclosure and accountability as the capital markets have grown and increased their investment in Polish banks.

III. The Poland Rating

The composite score awarded to Poland in 2000 is **3+,** an increase from **3/3+** in 1998, which generally reflects Poland's improving legal and regulatory structure, reasonably strong macroeconomic fundamentals, steady privatization in the banking sector, successful attraction of foreign investment from prime-rated institutions in the financial sector, credible capital markets, strong electronic advances, and growing recognition of the need for strengthened risk management systems as the market opens up to intensified competition in financial services and most economic activities. Ratings would be higher if Poland had a more stable macroeconomic outlook, developed judicial capacity, consolidated supervision, fewer troubled companies in heavy industry, closure in the privatization process of large banks and insurance companies, increased capital in the banking sector, more favorable earnings trends, better integration of strategic and

[1] These included: (i) annual reports and general financial data on a per bank basis for 1997 were not yet prepared by the time of the assessment—only a limited amount of openly disclosed financial information was available on balance sheets and income statements, and this was prior to the release of audited statements; (ii) while indicators from the National Bank of Poland provided a broad overview of annual results with a significant amount of useful information on an aggregate and segmented basis, information on individual banks and their portfolios was not included, nor is it today; and (iii) IMF statistics on the banking system were generally available only through end-1996.

risk-based internal audit functions with effective governance requirements, and more listings in the capital markets. Overall, the outlook for Poland should be viewed as favorable based on anticipated high levels of real economic growth, high levels of confidence by strategic investors, a positive reputation for institutional capacity in most cases, good prospects for large-scale privatization, and movement towards general entry conditions for accession to the European Union. Thus, as of mid-2000, the assessment of the Polish banking system is as follows:

The Polish Banking System—Summer, 2000	**Composite Score: 3+**

General Trends

The Polish banking system has moved through three stages of development in the last decade: chaotic competition from 1989-92 in the absence of a suitable legal and regulatory framework → stabilization from 1992-97 in which banks restructured and recapitalized, enterprises began to adapt to the new incentive structure, and the institutional framework was put in place for more orderly competition → 1998 on, a period in which the market opened up to full competition, strategic investors became more prominent, and there was a marked push towards retail banking based on the benefits of electronic capacity and the need for higher earnings and margins.

After a tumultuous beginning in the early 1990s, Poland focused on the turnaround of its commercial and specialized banks and the development of its supervisory capacity for safe banking, all in support of a more stable monetary policy and macroeconomic framework. Great progress has been made in this direction as the inflation rate has generally come down (notwithstanding recent monthly increases), banking supervision capacity has evolved in support of safety and soundness, and broad institutional efforts have been made by regulators and market players in support of financial sector stability.

Progress in the coming years will require movement towards effective consolidated supervision, enhanced cross-border coordination, and more suitable judicial capacity (i.e., judges, commercial lawyers specialized in finance, international standards of business conduct) for the challenges of complex financial institutions in an open market economy.

The Economy

The economy is in its ninth consecutive year of real GDP growth, averaging about 5 percent since 1994. Notwithstanding a comparatively unproductive primary sector, still needed restructuring in several key industries (i.e., steel, coal, defense) and high levels of unemployment (the latter of which reflect restructuring that is currently under way), Poland is still powered by the most dynamic private sector in the region. This has benefited from increasing trade and investment with Western Europe, and a sound monetary policy throughout most of the 1990s, although the inflation rate has increased for the last year, prompting high nominal and real rates of interest.

The rising inflation rate threatens to cause further increases in interest rates, and with it, default and increasing incidence of non-performance in loan portfolios. Short-term speculative capital inflows are also streaming into Poland as a result of the uncertain inflation outlook. In addition to inflation, current macroeconomic weaknesses remain in the fiscal and current account positions, with the former sensitive to political patronage with upcoming elections, and the latter being sustained at high levels on the strength of consumer demand.

However, there is significant market confidence in Poland, and this has received an international vote of confidence as Poland has attracted 40 percent of foreign direct investment in the region since 1998, and 30 percent among all transition countries during the same period. Thus, if FDI is used as a proxy for confidence, Poland has replaced Hungary as the darling of the region (partly because Hungary was the first to finalize most privatization), and could be considered one of the stars of the emerging markets world at a time when other countries face difficulties attracting needed direct investment. These trends should continue over the next two to three years, as strategic privatizations will continue through 2002. Meanwhile, signals of comparative global competitiveness will be transmitted more rapidly as Poland introduced a fully free floating foreign exchange regime in April, 2000. This replaced the crawling peg used since late 1992, and is a forerunner to joining the Euro zone in the coming years.

The Banks

At the structural level, the banking sector is showing intensified levels of competition. In 1998, this was already evident in the corporate market. By 2000, intensification of competitiveness is evident in retail markets. Majority-Polish and foreign-controlled banks have been developing new strategies, training personnel and expanding systems to capture new markets. Most noteworthy is the push into retail banking, supported by new branches and electronic means of transmission. As evidence, more than 52 percent of Polish households had at least one bank card in 1999, compared with zero in the mid-1990s. Consumer loans accounted for 6 percent of 1999 GDP, against less than 2 percent in 1995. Favorable impressions of banks have gone from 25 percent of the public in 1994 to 75 percent in early 2000.

Privatization has moved forward, with Pekao SA being acquired by UniCredito, BPH by HypoVereinsbank, and Zachodni by Allied Irish. Only two large troubled banks and a handful of smaller banks remain to be privatized. PKO BP, the largest holder of deposits in the banking system, is currently in the process of hiring a privatization advisor for what will likely be a sale through the Warsaw Stock Exchange and, possibly, other international exchanges. This will leave BGZ as the last major non-private bank, with its financial condition having improved in recent years. Investment has increased. In addition to recent privatizations, Commerzbank, Bank Austria-Creditanstalt, and Allied Irish have all increased their respective stakes in BRE, PBK, and WBK. Consolidation is also in evidence, driven largely by the presence of foreign banks. Citigroup recently acquired Bank Handlowy after BRE attempted to acquire Handlowy. The HypoVereinsbank-Bank Austria merger will have a direct impact on BPH and PBK, and possibly on Pekao SA in the long run given the shareholding position of Allianz. ING and Bank Slaski are discussing how they may merge operations in the coming years. AIB is considering plans for consolidation of WBK and Zachodni in the coming years. This will continue across financial services as well, as banks continue to take on major stakes in insurance companies, pension funds and other financial services.

While banks are expected to be more competitive in the coming years, they must face current trends that show poor earnings performance, lower return ratios against average equity and assets, and continued investment costs in the coming years for market positioning. Earnings performance is also threatened by rising inflation rates, and the adverse impact this might have on loan exposures if there is a material rise in the level of defaults in the economy. Banks will also need to be able to manage their foreign exchange risk, as short-term speculative inflows are likely to add volatility until inflation is brought under more control.

Prudential Considerations

Capital has nearly doubled in the last two years, but remains low by global standards—only $112 million per bank at end 1999, compared with about $60 million on average in 1997—even if risk-adjusted capital ratios show adequacy. About one third of Poland's banks are barely above the EU minimum for capital, which is not enough to compete in today's environment except in the narrowest of services. It is perfectly conceivable that these 23 banks, along with the five smaller public banks, will be consolidated with other organizations in the next few years. Given existing affiliations in the banking sector, this could bring the number of banks down from 77 at end 1999 to as few as 30-40 within the next few years, and even fewer thereafter.

Asset quality remains suspect in some portfolios as banks take on increasing risk. However, strict provisioning requirements have been applied to risky sectors, and irregular loans have been kept under reasonable control.

Earnings have been weak over the last two years. These are reflected in the aggregates for 1998-99, which were less than half the earnings generated in 1996-97. Return measures reflect tightened margins in traditional areas of lending, higher provisioning, and higher overall operating costs. On a positive note, non-lending sources of income have increased for most Polish banks, largely foreign exchange trading, commissions and fees.

Liquidity is strong for the banks, and an easing of reserve requirements eased up resources for incremental lending. However, Poland's funding base is still relatively low, composed 62 percent by deposits (nearly half of which are held by two banks) and 17 percent by the inter-bank market. These are supplemented by international borrowings (which are subject to exposure controls). Larger institutions are likely to serve as a catalyst for more active bond and capital markets over time. Growth of institutional investors from the insurance, pension and mutual fund markets will play a key role here.

Overall, the operating environment has continued to improve as competition has become more open and transparent. However, there are still many risks that remain for the Polish economy and banking sector. Governance and management systems need to be further strengthened at some institutions as financial services become increasingly universal, complex and competitive. This will require improved risk management systems across financial services—banking, insurance, investments—based on improved board oversight, more autonomous and professionalized internal audit functions, and enhanced capacity to utilize meaningful information for strategic management purposes. These weaknesses were identified in 1998, and more needs to done at some institutions while others have clearly moved forward with improvements.

There is also the unanswered question of the quality of banks' portfolios and underlying assets in the event of an economic slowdown. This question was raised in 1998, and the economy has continued to grow at reasonably high real growth rates. With indicators positive for Poland's major international trade partners (mainly Euro-based), this question is being deferred once again. However, underlying asset quality is likely better than presumed two years ago, as Poland withstood "contagion" challenges reasonably well.

The current risks appear to be interest rates (due to stubborn inflation indicators) and the risk of default if rates are hiked again, the continued high current account deficit (largely the result of consumer spending) which has prompted short-term capital inflows of a speculative nature, and the possible loosening of fiscal policy with presidential elections in 2000 and parliamentary elections likely in 2001. Should these contribute to more volatility in foreign exchange markets and have a more direct impact on changing asset values, banks' portfolios could be exposed. Likewise, should large borrowers have high exposures that are unhedged, losses could translate into weaker capacity by companies to service and repay bank loans. These are likely well managed, but should remain issues of concern to market players and regulators.

General Indicators

- Poland's banking system has been majority private since 1998, and should be 100 percent private by 2002-2003; private banks already account for about three quarters of balance sheet values, and most fee income
- Foreign investment and consolidation have increased significantly; the number of banks could decline from 77 at end 1999 to 30-40 banks in the next few years, as about one third of banks have less than Euro 10 million in capital, and five other public banks will likely be merged/privatized
- Deposits are still concentrated—three banks account for about 50 percent of total deposits—and other funding sources are limited; however, intermediation rates continue to show growth, and three quarters of deposits kept with banks are term deposits, which provide underlying funding stability
- Competition has spread from corporate to retail, resulting in tightened margins; weak earnings in recent years could prompt riskier lending, foreign exchange trading, and other activities which are costly to manage in an effort to offset declining margins
- Tier I and II capital are adequate—the system had risk-adjusted capital of 13.2 percent at end 1999 against 11.7 percent in 1998
- Total capital for the system was $9 billion at end 1999, up from about $6 billion at end 1997

• 1997 ROA: 2.0 percent • 1997 ROE: 24.7 percent	• 1998 ROA: 0.7 percent • 1998 ROE: 9.1 percent	• 1999 ROA: 1.0 percent • 1999 ROE: 14.2 percent

The basis for the composite is described by each of the four general activities and the 28 sub-categories below. A more expansive review is attached as Annex 2, following the same format as the summary report, but providing significantly greater detail.

Section 1: Assessment of Financial Sector Infrastructure	
I. Financial Sector Infrastructure: Score: 3+	**Poland has made significant strides towards financial sector modernization in the last few years, with prime-rated foreign investment and increasing electronic capacity constituting the biggest changes since 1997-98. Strategic investment has materialized from the privatization of Pekao SA, BPH and Zachodni, as well as from an increase in investment from institutions that had earlier invested in banking franchises in Poland. More recently, Citigroup's acquisition of Bank Handlowy signaled that institution's continued commitment to the Polish and regional market. While two major banks still remain state/Treasury-owned, Poland has generally moved down an irrevocable path of private ownership in the banking system over the last few years, with particular focus on strategic investment since 1997.** **Investment in electronic capacity permeates the system, and has been partly driven by the public sector—NBP has required that banks transmit regular reports electronically for years, and more recently, GoP has mandated that all pension payments be done through the electronic payment system. The Y2K effort also required investment in new systems. As elsewhere, banks in Poland are recognizing the need for heavy investment in new systems for operational efficiency and regulatory compliance, as well as to provide a broader range of services to the market.** **While financial intermediation statistics are still lower than in EU countries, general trends are favorable. Lending and deposit mobilization have increased, the range of maturities has expanded, rates have come down, and more people and businesses now have accounts. Polish banks are providing a wider range of services than just a few years ago, and this will continue as the banks become more competitive and as universal banking takes hold. Already, public opinion of banking has improved over the last two years, partly because competition is driving banks to be more service-oriented at the retail level.** **Poland's strengths continue to be a growing economy geared to EU and global markets, increasing liberalization and investment in the banking sector, high standards of accountability, increasing professionalization, and supervisory structures for banking, insurance and capital markets that are based on guidance from the Basle Committee on Banking Supervision and the Joint Forum on Financial Stability. Legal reforms in banking introduced in 1997—The Banking Act and The Act on the National Bank of Poland—reinforced these structures and provided a broad mandate for enforcement. Amendments are being introduced in 2000 to account for the needs of consolidated supervision, to toughen penalties and sanctions, and to prevent a repeat of recent scandals in the banking and insurance sectors.**

	There is a need for better technical coordination among regulatory authorities to identify and monitor for financial sector risks, and sufficient capacity to ensure that life insurance and pensions are properly managed so that policy holders benefit from adequate consumer protection standards. The framework is already in place and evolving, as EU guidelines are being used to map out developments in the pension and insurance sectors. Proper oversight of financial condition, investment policy, consumer protection and potential links to systemic risk in the banking sector may become more of a challenge in the insurance sector as this market matures in the coming years. **Governance at the state commercial banks and major private banks has improved since late 1993. The 1997 Banking Act spells out basic governance requirements for all banks, including state and cooperative banks. Privatization moved forward over the last two to three years, and there are now only two major banks and five smaller banks that remain in non-private hands. Membership in the OECD and future entry into the EU are all providing momentum for institutional reform.** **Poland's payments system has improved in the last two years, with all branches now linked electronically and evidence of a gradual decrease in paper-based transactions as a percentage of total.** **Accounting standards have been moving increasingly towards international norms, sustained largely by requirements for the largest reporting banks, the due diligence process that comes with privatization and larger joint-ventures involving equity stakes, and demands from the market on companies trading in the capital markets. However, there is still reported to be a big gap between the Big 5 firms and local Polish accounting firms in terms of accounting and audit standards.** **Poland continues to benefit from support organizations that enhance and help sustain market development—rating agencies, professional associations, media, academic and training institutes. Advances in the telecommunications sector have also helped with overall modernization efforts.**
1.1 Policy and System: Score: 3+	Poland was earlier perceived to be partly protectionist with regard to several "strategic" sectors (e.g., coal, steel, agriculture), and slow with privatization. While there are still about 3,000 non-private firms, Poland has moved towards full implementation of a market economy over the last few years. This is particularly evident in the services, where private companies dominate. In the financial sector, there has been clear movement towards a private banking system. The insurance sector has not moved as quickly, although the plodding privatization of PZU and significant investment from foreign insurers in recent years will ultimately transform insurance into a private sector-driven one. The capital markets are relatively small, but they are well regarded and did not suffer the same level of turbulence and outflows as experienced in many other emerging markets in recent years.

	More generally, Poland has shown considerable economic growth in real terms since 1994. If there were earlier doubts about the environment for foreign investors, these concerns appear to have abated in recent years as foreign direct investment has increased considerably. General weaknesses exist with regard to labor productivity in the troubled coal and steel sectors, and the lack of competitiveness of many SMEs. However, Poland is perceived to be on the right track, largely the result of its membership in OECD and movement towards entry into the EU. While there are reports that negotiations with the EU have slowed and that entry will not occur for several years, this is also partly because Poland has taken issue with the EU on the Common Agricultural Policy, and other issues within the EU that have an effect on restructuring within Poland (e.g., overcapacity in the steel sector). Poland has introduced major reforms in recent years that will ultimately create capacity to assume the obligations of EU membership. This includes privatization in the banking sector, increasing private investment in the insurance and telecommunications sectors, and major reform of the social insurance system. Poland has also shown its commitment to democracy, free trade, and multilateral cooperation. Poland's legal and regulatory structure has been partly reformed to conform to these prerogatives, even if judicial systems and capacity still require improvements. At the structural level, Poland's banking and financial system have undergone considerable reform since 1989. Its regulatory structures are considered reasonably strong, and this should provide for added institutional security in banking, insurance and capital markets in the coming years as trade and investment in financial services increase. In the real sector, there is recognition of the need for additional investment and increased productivity, particularly in the primary and secondary sectors. Agriculture remains a particularly difficult challenge due to traditional ownership patterns, demographics, and political resistance to change. Recent challenges in the merchandise trade accounts have pointed to the need for industrial modernization, some of which is beginning to occur in the form of capital investment and reduced head count. Services represent a steadily increasing share of GDP and employment, which is consistent with patterns elsewhere in Europe.
1.2 Legal: Score: 3	Poland adopted the Banking Act and the Act on the National Bank of Poland in late 1997. This legislation brings much of the legal framework for banking in line with minimum EU standards, OECD member requirements, and BIS guidelines. The two Acts, representing improvements from earlier pieces of legislation, were also meant to provide a legal mandate to alleviate what had been problems associated with judicial infrastructure and the timely processing of claims, uncertainties regarding collateral and contract enforcement, and debt collection. Poland's legislation is generally considered satisfactory, although further changes are being discussed now to incorporate recommendations from BIS and the Joint Forum on Financial Stability, and to move Poland increasingly towards effective consolidated supervision to contain financial sector risks. There are still weaknesses with regard to judicial infrastructure. Courts are

	overwhelmed with case loads they can not handle. Staffing and compensation levels are insufficient. More training in commercial practices is considered necessary. With regard to banking, membership in the OECD has been accompanied by a major push for liberalization and consolidation, particularly since 1997-98. Poland's legislation recognizes home-country rule and mutual recognition principles in a manner consistent with EU Directives. However, Poland is taking the position that full opening will not occur until Poland becomes a member of the EU, which will not likely occur before 2002, and may not occur until 2005 or later. Banks' interest in securitization, consumer lending, "plastic cards," and mortgage lending has led to additional legislation. This legislation is considered to be broadly consistent with EU norms.
1.3 Regulatory and Supervisory: Score: 3+/4-	Poland's banking supervision department—known as the General Inspectorate of the National Bank (GINB)—represents one of the strengths of Poland's overall financial infrastructure and institutional capacity. The regulatory framework conforms to prudential guidelines rendered by the Basle Committee for Banking Supervision, as well as more recently with EU directives and guidelines more consistent with "universal" banking practices. The banking supervision department of the NBP was introduced in 1989 with the break-up of the monobank system. After an initial period of crash liberalization in which Poland sought to rapidly transform itself from a centralized command economy to a market-based system, Poland introduced a more prudent approach to banking regulation and supervision in 1992 when the magnitude of banking sector problems was beginning to be realized. While the initial period of supervision introduced a basic prudential regulatory framework and reporting requirements, these were not effectively implemented. Since 1992, banking supervision has been focused on building capacity to contain systemic risk in the banking sector and to support NBP's larger objective of price stability. This was largely predicated on legal changes to the Banking Act in 1992, which empowered NBP to issue legally binding resolutions to which banks had to adhere. As elsewhere in the region, this was most directly illustrated in changes in provisioning requirements and loan classification standards, bringing to the fore a more accurate understanding of underlying asset value and capital adequacy. New accounting practices, valuation standards and risk weights exposed the financial and capital weaknesses of the banks, and set in motion a whole series of requirements for safe and sound banking. Legislation in 1997 altered the role of the GINB. In one sense, it was expanded to play a major executory role on behalf of the Commission for Banking Supervision (CBS). On the other hand, its role was potentially diluted by the presence of a broader composition of the Commission through which GINB is required to coordinate its activities. While there has been reasonable coordination at senior levels of the CBS, there appear to be weaknesses in coordination at more technical and operational levels. If Poland moves increasingly towards integrated, risk-based, consolidated supervision, these weaknesses will have to be remedied. Nevertheless, overall, GINB is perceived

to be effective in its oversight of the banking system. It has avoided some of the weaknesses found in many other neighboring supervisory agencies, such as inadequate internal coordination (e.g., policy, strategy, on-site and off-site), coordination at senior levels between/among differing regulatory authorities, reluctance to use on-site inspections, reluctance to apply enforcement mandates, and inability to retain competent and trained personnel. However, as noted elsewhere, these and other areas/practices can be strengthened in Poland.

Within GINB, it is believed that there could be better coordination between off-site surveillance and on-site inspection strategies and timing. Coordination with other regulators will be needed as universal banking takes hold. Enforcement mandates and penalties/sanctions are not always as strong or as rapid as they need to be, as shown in the case of Bank Staropolski. The non-privatization of some of the largest Polish banks also undermines GINB's mandate to enforce supervisory actions in a manner similar to private banks. Additional weaknesses in 1997-98 were at the technical level and rooted in insufficient information, the nature of some reporting forms and methodologies, the need for increased training in risks associated with derivatives—mainly foreign exchange, interest rate, and pricing—and mortgage lending, and the need for more targeted inspections when risks were identified, as opposed to comprehensive examinations.

There may be inadequate information generated from banks regarding off-balance sheet risks (e.g., guarantees, third party transactions) which could undercut the ability of NBP to identify, evaluate and contain risks early enough for a targeted inspection or corrective action. On the other hand, actual exposure risk may be understated as many companies have not hedged their positions due to high transactions costs. Major risks to underlying stability are cross-ownership affiliate relationships, as with Bank Staropolski. This could be a particularly serious risk when non-regulated financial entities own banks, or when they are large borrowers from banks and supervisors lack adequate access to their financial records, preventing portfolio reviews to test for bank soundness. There could also be undisclosed risks in consumer lending and exposure to leasing finance companies. In the past, NBP has required that banks fully provision for exposure risks to leasing companies. A conservative approach has also been in place with regard to consumer lending, where the highest growth rates have occurred in bank lending. Likewise, there may be inadequate information reported to NBP from banks regarding the links between interest rate, exchange rate and maturity risk. Many banks are currently borrowing in foreign currency and lending in zloty. Reporting forms to NBP are in zloty. This conversion may gloss over the exposure some banks have in the event of a material shift in the exchange rate. However, given the introduction of a fully free-floating exchange rate, the key here is for banks to have the systems in place to manage these risks, with GINB/NBP monitoring those banks for their systems and capacity.

One weakness that appears to still be in place is the absence of repricing data on loans and deposits, particularly as the market moves to an increasing proportion of variable rate instruments in a period characterized by higher

	inflation rates, the risk of higher interest rates, and increasing portfolio inflows. More specific forms which show the actual currencies, exchange rates, interest rates and maturities of borrowings and loans on a weighted and time-to-maturity basis might assist NBP with its surveillance. While it is assumed that the banks themselves have all this information, the ability of NBP to manage monetary policy and CBS/GINB to focus on overall financial sector stability is partly undermined by incomplete information.
1.4 Payments System: Score: 3+	Poland's payments system has undergone considerable modernization in the last two years. Three years ago, about half of all banks were participating in the fully electronic system. However, smaller banks were constrained by their own internal capacity and limited investment resources. Further, they often benefited from float in a higher interest rate environment. Since then, major investment has been put into electronic systems, and bank branches are all fully linked to the system. The proportion of paper transactions has diminished, and clearing and settlement take no more than three days. While not real time, this compares with earlier approaches that relied on paper and courier services, high levels of manual inputting, and generally slow processing of transactions. Investment in electronic capacity and more modern payments systems has made it possible to accommodate the banking sector's ambitious plans to increase credit and debit cards, point-of-sales terminals, ATMs, and a general increase in electronic volume. In terms of risk, the earlier system presented no systemic risk because settlements were conducted on a net basis, and did not occur unless funds were available from the debtor bank's account held at NBP. With electronics, the same approach can be applied with a greater degree of accuracy. The latter is due to capacity for more precise liquidity management practices and routine safeguards built into the system. Until recently, most banks estimated their funds at daily closing and maintained surpluses at NBP for insurance. This was particularly burdensome to the banks during restrictive monetary periods. Today, banks are able to tally their accounts faster and more precisely, thus retaining funds for their own earning asset accounts. Any security risks—financial, managerial or operational—are reported to be manageable.
1.5 Accounting: Score: 3-/3	Poland adopted the Accounting Act of September 29, 1994 to bring the country's accounting standards more in line with IAS and the EU Fourth Directive. Prior to this legislation, most statements had been produced for tax purposes and for the Central Statistical Office. Accounting regulations are waived for public sector entities and small businesses of any sort with net sales of goods and finished products plus financial income from the preceding year of less than Euro 800,000. Businesses with no more than 50 employees on average throughout the year, with total assets of no more than Euro 1 million, and with ordinary income of no more than Euro 2 million are permitted to prepare simplified statements. In Poland, this amounts to about 2.5 million businesses. However, other companies are expected to comply with standards, which are more rigorous as the size of the firm increases. All major banks are required to prepare statements according to IAS, as

are insurance companies and all companies listed on WSE, irrespective of income figures. This includes the preparation of consolidated financial statements. In the case of larger firms and firms with foreign participation, statements are expected to conform to IAS and are prepared with the assistance of international accounting firms based on International Standards of Audit. This includes consolidation standards applied to intercompany balances and unrealized gains/losses for subsidiaries and associated companies. Notes are used to provide needed explanations underlying balance sheets, income statements, and for larger companies, cash flow statements. These explanations include but are not restricted to depreciation schedules and the impact on fixed asset values, collateral in assets owned by the company, an analysis of share ownership, movements in capital, reserve and provision accounts, creditor maturities, contingent liabilities, tax reconciliations, information on nonconsolidated joint ventures, and loans/compensation to board members and directors.

In addition to being a standard for larger firms or being prompted by regulatory requirements in the financial sector, IAS has been a fundamental element of valuations, due diligence, and investment decision-making (both for direct investment and portfolio investment) since Poland began opening its markets. Thus, Poland's accounting standards are evolving increasingly towards international standards.

However, numerous weaknesses remain in Poland's accounting framework, some of which may point to potential risks for bank portfolios. In many cases, accounting is still conducted on a tax-oriented cash basis rather than on an accrual basis, particularly for small businesses. This is more the result of years of tradition rather than the fault of the new framework. However, it does represent a tiering of the market, differentiated by firm size. What this provides is a basis for smaller firms to understate income or overstate expenses to avoid tax payments, whereas larger firms have an incentive to overstate assets or understate liabilities to increase access to secured loans. There are also problems related to the timing of consolidated statements.

All the major international accounting firms have been active in the Polish market since 1990. Meanwhile, there are many more Polish accounting firms, although they tend to be smaller in scale, relatively new, and unable to provide many of the financial advisory services that are needed for ordinary Polish companies to strengthen management and competitiveness. What is lacking structurally in the profession is a "middle-market" segment of the accounting profession which is less costly than Big 5 audit firms, yet more sophisticated than most existing Polish firms.

It was the opinion of some international auditors a few years ago that there was a lack of political will on the part of the Ministry of Finance and the Polish Institute of Chartered Auditors to introduce national standards that would be universally accepted for widespread use. Today, it is appears there is consensus to move forward with a revamping of accounting legislation, and to strengthen accounting and audit standards. Changes are expected in related-party transactions, leasing, deferred taxation, and general standards of audit to ensure accurate financial reporting. These are all of critical importance to bank exposures and portfolio quality. However, it will also take time. The demographics of the profession point to the need for new entrants and significant (re)training of existing capacity.

1.6 Rating Agencies: Score: 3	All the major international rating agencies have been active for several years in the Polish market. Poland's credit ratings on currency as of May 2000 were generally favorable and investment-grade. These were A2 by Moodys, A+ by S&P, BBB+ by Fitch IBCA, and A- by Duff & Phelps. A domestic rating agency—CERA—was established in 1996, but its efforts have been partly constrained by information flows, concerns about confidentiality, and less enthusiasm exhibited by shareholders than originally expected. It has been able to attract Thomson Bank Watch as a strategic investor, and this might enhance its credibility over time (although initial impressions are less than overwhelming). To date, CERA has rated about 15 securities to be issued to the public, including company issues and municipal bonds. CERA has also rated another 12 issues on an unpublished basis. About half have been for banks. CERA is optimistic that it can play a role in the domestic banking market by using its ratings methodology to assist institutions in their assessment of counterparty risk. CERA also expects the mortgage bond and commercial paper markets to grow.
1.7 Financial Media: Insufficient Basis for a Score	No particular effort was made to assess the financial media. However, there are several newspapers that report daily and weekly monetary and financial information. Market research firms conduct surveys for continuous feedback from the public. There are also many English-language journals. Media coverage is generally considered responsible. An effort has been made through Mediabank (in which the Polish Banking Association has a 33 percent stake) to provide greater information to radio, television and journals on developments in the banking industry—including product offerings, new lending trends, and other news that is relevant to the public. PBA believes this has contributed to higher customer satisfaction ratings with the banking sector. There are also many web sites with information on the banking system and economy. Meanwhile, NBP and the Monetary Policy Council have pursued more open communications strategies to ensure the public is better informed about economic targets, monetary policy, and likely movements in interest rates and other measures. These have been reported broadly in the financial media.
1.8 Professional Associations: Score (for PBA): 4	There are 33 Chambers of Commerce in Poland, with a total of 6,655 members, or about 200 on average. These associations are generally organized along regional, bilateral, or trade/specialized areas of focus. In the third group, sectors covered include agriculture, mining, industry, furniture, SME crafts, printing, telecommunications and pharmaceutical producers. In addition, there are several professional associations in Poland for financial sector individuals and groups. Among the largest are the Polish Banking Association (PBA) and the Polish Chamber of Auditors. The PBA remains engaged in the drafting of legislative initiatives, and enjoys observer status at meetings of the Committee for Banking Supervision. PBA is engaged in a number of initiatives that have accelerated market development in the banking sector. Recent initiatives have included a key organizational role in

	promoting development of the payment and settlement system, support for the local credit rating agency (CERA), development of the credit information bureau being launched in 2000, and coordinating input on a regular basis from the banks to NBP with regard to regulatory and supervisory initiatives. Other PBA initiatives dating back to 1998 and earlier include a shareholder role in establishing the national clearinghouse (KIR) for bank settlement, development of the TELBANK system, and managing a modest data bank on delinquent borrowers. It is specified in the Act on the National Bank of Poland that a representative of PBA participate in meetings of the Commission for Banking Supervision on matters that relate to regulation and supervision in the banking sector, including when CBS discusses issues related to safety and soundness. Thus, PBA has been and is considered important in coordinating input to/from banks and legal/regulatory authorities. Its membership is voluntary, yet it includes all banks as members as well as some of the larger cooperative banks. The Warsaw Institute of Banking, established in 1992, is closely associated with the Polish Banking Association, and has played a leading role in coordinating some of the technical assistance and training activities that have been financed over the years by donors. In 1997-98, this had included the training of more than 3,000 people working in more than 50 Polish banks. These numbers have grown in recent years, and this has served as a complement to other business and training institutes that have provided some of the human capital of the banking industry. In the accounting and audit profession, the Polish Institute of Chartered Auditors has 2,500 members, and is now providing some post-qualification training and examinations for ongoing professionalization through its institute. The Chamber is also responsible for licensing auditing firms. The Institute has introduced post-qualification training and examinations as part of its efforts to contribute to the strengthening of the audit profession.
1.9 Academic: Insufficient Basis For a Score	There are currently at least 32 business schools in Poland, with more than 125,000 students enrolled. This would mean the addition of at least 30,000 trained entrants to the work force each year, assuming the average program lasts for four years. Most of the schools were established in the early or mid-1990s, although some were established earlier, including one founded in 1816 (by Tsar Alexander II). No particular effort was made to assess the quality of academic institutions in Poland, nor was there a systematic effort to speak with business/management school officials. However, Poland continues to benefit from many schools, institutes and think tanks that are able to make a significant contribution to banking sector development. Most have cooperation agreements with economics, business, finance, management and marketing programs in Western Europe and North America. However, there is a question of whether these schools are able to produce enough graduates to meet the growing needs of the financial and corporate sector for skilled, knowledge-based employees. This risk may be compounded in the future as EU countries, North American markets and other economies seek to attract skilled personnel. Most large financial institutions are investing heavily in training, and recent figures from NBP indicate that personnel costs are going up, including salaries.

1.10 Miscellaneous: Score: 3+	In Poland, overall electronic and telecommunications capacity is rapidly increasing to compensate for what was one of the least developed systems in the region. Investment in these areas is clearly evident in the banking and financial sector, as many banks are spending to improve their internal information and communications systems for better management and the provision of a wider range of services. Part of this has been prompted by NBP, which required electronic reporting of UBPRs back in 1997. Poland started the 1990s with one of the least developed telephone systems in Europe. Even by ex-communist standards, the system was poor—only 8 percent of the population had access to main-line telephone service, and service levels were poor. Even in 1996, there were only 169 telephone mainlines per 1,000 people in Poland, which lagged the Baltic States and were about on par with most of the European part of the former Soviet Union. Today, it is estimated the number of mainlines per 1,000 has increased to more than 219. Mainlines are still short of EU standards, although the gap is narrowing. The government has pursued a program to modernize infrastructure in advance of privatization of the major telecommunications company, TPSA, which was wholly state-owned until 1998, when it sold 15 percent to the public in an IPO. More recently, GoP announced that an additional 25-35 percent will be sold to France Telecom and Kulczyk Holdings. Additional competition has been introduced for long-distance connections as well as for local phone services, although TPSA remains the giant with 8 million fixed-line subscribers. Its leading competitor appears to be Polska Telefonia Cyfrowa, a subsidiary of Elektrim that is operating in the mobile phone market, with 1.8 million cell phone subscribers. However, as of early 1998, private companies only serviced 170,000 fixed line telephones in 31 of 49 voivodships, as opposed to TPSA's 7.5 million telephones in all 49 voivodships. Investment requirements of $1 billion or more per year for network expansion were greater than the resources that TPSA could provide. For this reason, GoP moved more quickly with liberalization and the introduction of more competition in the telecommunications sector over the last two years. This has resulted in more than 30 major hardware, software and systems integration companies that have filled much of the gap and helped Poland advance in this critically important sector. Postal services appear adequate, as does safekeeping from a physical and logistical standpoint. Part of the investment made by banks has been to strengthen their electronic systems for increased protection, particularly as ATMs, point-of-sales terminals, debit-credit cards and other features have been introduced more energetically in the last two years. GoP and NBP have also played a pivotal role, particularly with regard to Y2K preparations, reporting requirements, and pension payment flows. The recent announcement by Citigroup of its plans in e-banking serve as a harbinger of the future, with a significant expansion of internet banking and e-based commerce on the horizon. Already, this is in evidence with newly introduced retail networks from Bank Handlowy and BIG Bank Gdanski.

Section 2: Assessment of Economic Factors and Private Sector Indicators

II. Economic Factors and Indicators: Score: 3+

Poland's economy has been evolving into a private sector-oriented system in terms of ownership, employment and contribution to GDP for the last several years. While much of industry remains in state hands and agriculture needs to be modernized, the Polish economy has grown over the last several years on the strength of its private sector. This includes more than 5,000 privatized companies that have generated substantial privatization proceeds over the last three years, equivalent to 1.3 percent of 1998 GDP and 2.2 percent of 1999 GDP.

Major privatizations concluded or ongoing over the last few years have involved Pekao SA (banking), LOT (aviation), PKN Orlen (petrochemicals), TPSA (telecommunications), PZU (insurance), and power sector entities. Poland has seen more than 2 million companies established that are relatively new, and this has contributed to a buoyant SME sector that contributes nearly 50 percent of GDP and serves as a major employment generator. Consequently, Poland gets good ratings for small-scale privatization, but mediocre ratings for large-scale privatization.

A majority of Poland's top 100 companies are still owned by the state/Treasury, and only eight have been privatized in the last two years. Forty percent of the industrial work force remains employed by SOEs, although these numbers are beginning to decline. Where privatization is hard to achieve, such as for troubled coal mines, steel companies, non-ferrous metals producers, coke producers, and some machine tool manufacturers, restructuring plans have been put into place. This has been true in some of the major steel firms (even though privatization plans have been delayed or targets missed), and in the coal sector where mines have been closed, production cut and the work force reduced by about 25 percent. The target has been to sell virtually all state enterprises by 2002 apart from the post office, railways, and troubled coal mines, although this schedule could be delayed with a change in government and unclear timing of entry into the European Union. Under any scenario, significant privatization is expected to be finalized in a range of industrial sectors as well as in banking, insurance, power generation, telecommunications and transport by 2002.

Meanwhile, Poland gets good ratings for its trade and foreign exchange system, having removed most quantitative and administrative restrictions that apply to international trade as far back as 1990, having introduced a fairly uniform customs regime and current account convertibility, and having virtually eliminated government interference in export-import flows from state trading monopolies (likewise in 1990).

The capital account was liberalized in 1999, as the new foreign

exchange law eliminated restrictions on internal foreign exchange transactions between banks and non-banks. The current account was liberalized several years earlier, and portfolio flows have been fairly significant over the years. NBP reserves the right to intervene to protect safety and stability in the financial sector. Nevertheless, for all intents and purposes, the capital and current accounts have been liberalized. Movement towards a fully free-floating exchange regime indicates the market will set exchange rates.

Competition and pricing policy are generally harmonized with EU legislation. Most trade protection has been removed, although remaining barriers—mainly in agriculture—are still in place and are creating some negotiating friction with the EU. Nevertheless, it is expected that these will also disappear or diminish in the coming years for Poland to comply with a host of international agreements and obligations.

There has been growing FDI since 1996, totaling $18.9 billion from 1996-99. FDI has been invested in the automotive, food processing and power plant sectors, telecommunications, and banking and insurance. While Poland is competitive in a number of products—about 70 percent of its international trade is with EU markets—it has been challenged recently by the decline in eastern markets, competition from other regional producers, and net outflows on the services account. This has manifested itself in high current account deficits in recent years, reaching as high as 7.6 percent in 1999.

A major structural challenge in the coming years will be the outcome of new efficiencies and investments in the industrial sector, and to see if competitiveness in this sector serves as a catalyst for smaller firms to grow. A second challenge will be managing the balance of payments as higher levels of debt service come due in 2002-2006. For now, the outlook is positive due to high FDI inflows, and the likelihood of continued portfolio investment. However, competitiveness in the SME sector may also depend on reduced bureaucracy, higher labor productivity, and further development of equity markets. This will require higher levels of transparency and disclosure than many are currently used to. Moreover, banks and the bond markets will need to continue to develop for companies to obtain needed debt financing for long-term needs.

Banks have shown a willingness to lend in recent years, but this cannot be guaranteed as automatic for most firms. However, trends have been more auspicious in recent years, with banks and others increasing capital, expanding their investment in retail networks, and providing a broader array of services. Meanwhile, until recently (3Q1999), inflation rates and interest rates have come down, reducing the cost of credit to companies. While the funding base for banks is still relatively thin, more people have term deposits. This has increased the funding base for banks, and should also contribute to lower rates on loans over time.

2.1 General: Score: 3+

Poland has several economic weaknesses, including a growing current account deficit, rising levels of debt, fiscal deficits, and stubborn inflation and unemployment rates. Nevertheless, Poland's economic indicators are broadly favorable at the macroeconomic level.

Growth has been high for several years, although real GDP growth was at lower rates in 1998-99 than in the previous four years. This slowdown was due to some sluggishness in Western Europe, troubles in Russia and neighboring states, and general skittishness of international investors in emerging markets in 1998-early 1999. However, after declines in 1990-91, Poland's real GDP is in its ninth consecutive year of real growth—powered mainly by the growing private sector and, more recently, strategic investment in major privatization transactions. From 1994-97, real growth rates averaged 6.25 percent. This declined to 4.8 and 4.1 percent, respectively, in 1998-99.

Official unemployment has fluctuated over the years, peaking at 16.4 percent in 1993 and dropping to 10.3 percent at end 1997. However, unemployment is back up to more than 13 percent now, roughly comparable to 1992. All together, a net 885,000 jobs have been created since first quarter 1994.

Tight monetary policy has brought the inflation rate down steadily—from 70 percent on average in 1991 to an average 32 percent in 1994, 14 percent in 1997, and about 7.3 percent in 1999. The year-end 1999 CPI rate was 9.8 percent, higher than the 8.6 figure at end 1998. Inflation continued to rise in early 2000, and the current annual rate (as of mid-2000) is 11.6 percent. This raises the risk of higher interest rates, and with that, the potential for higher rates of default and portfolio performance weaknesses. Nevertheless, overall, Poland steadily brought down the inflation rate in the 1990s. With a 6.8 percent upper bound set as a target for year end by the Monetary Policy Council, it is expected that the inflation rate will begin to soon decline, although these prospects are partly offset by high sustained oil prices and potential risks to dramatic interest rate increases imposed by the MPC.

The government fiscal deficit has declined from a high 6.7 percent in 1991-92 to about 3-4 percent since 1993. These figures include local government and off-budget items that go to assist loss-making enterprises in coal, steel and other selected sectors. Health and social insurance costs accounted for a sizable portion of the deficit. Budget subsidies to enterprises have declined in Poland in the 1990s as enterprises have been privatized, and as Poland has sought to get its fiscal house in order. Pension/social security costs remain high, but the new pension reform introduced in 1999 is expected to reduce this burden to the budget over time. In general, the fiscal picture has improved in recent years as the economy has grown, revenues have increased, and expenditure has been brought increasingly under control. Reduced rates on investments in government securities serve as an example of the easing of pressure on government finances.

Exchange rates depreciated against the dollar in late 1999 after appreciating in 1998. Poland has experienced a steady and significant increase in international trade—total merchandise exports and imports were about $74 billion in 1998, more than three times levels in 1991 and more than twice levels achieved through 1994. The current account deficit was $11.7 billion in 1999, equivalent to 7.6 percent of GDP. This represents a major increase from $4.5 billion in 1997, when the current account deficit was 3.1 percent. Meanwhile, gross international reserves declined for the first time since 1995, falling from $27.4 billion at end 1998 to $25.5 billion at end 1999, equivalent to about six months of import coverage of goods and non-factor services. This compares with about three months' coverage from 1991-94. Portfolio flows have grown steadily since 1994 with increasing liberalization and capital markets development, providing short-term financing. More importantly since 1998, FDI has grown significantly, accounting for more than $13 billion in inflows. This compares with an unimpressive $2.6 billion from 1989-1995. Thus, in these two years, annual average per capita FDI has increased from less than $10 from 1989-95 and $61 in 1996-97 to $167 in 1998-99. Expectations are that FDI will be sustained at comparable levels for the next two to three years, and then portfolio flows will become more prominent.

2.2 Private Sector Development: Score: 3+/4-

Private sector shares of employment and GDP are reasonably high—estimated by EBRD at about two thirds. Much of the strength of the Polish economy is derived from the dynamism of its small business sector. By the mid-1990s, Poland had nearly 2 million businesses that were individually owned, and about 100,000 private companies that were joint stock companies or joint ventures. However, Poland still has about 3,000 SOEs, and some of Poland's largest companies and exporters are majority or wholly state/Treasury-owned. Thus, while Poland is moving irrevocably to a private sector-dominated economy, there is still a strong presence of the state/Treasury in many key industrial and service sectors. More than half of Poland's 100 largest companies have state/Treasury ownership.

The private sector had already established its dominance in commercial trade—wholesale and retail—and construction, and was about even with the state sector in industrial output by 1996. Since then, investment trends have indicated a growing share from and into the private sector. Most recently, this has come from FDI.

In terms of employment, the private sector dominates in agriculture, manufacturing, construction, trade, and real estate and other business services. Paid employment figures point to about 70-75 percent of people employed in the private sector.

Privatization plans of the current government are to have virtually all enterprises in private hands by 2002, with the exception of the railways, postal system and troubled coal mines. This could push private sector shares to 90 percent or more by 2002. Major privatizations in process include PZU (insurance), TPSA (telecommunications), the two largest oil refineries, and several power stations. One other major privatization in 2000 is expected to be for shares of KGHM (copper).

In the banking sector, it remains to be seen how and when BGZ and PKO BP will be privatized, although PKO BP is likely to float shares on the WSE with share distributions included for employees and pension funds. Over time, it can be expected that management would sell shares, and that strategic investors might eventually assume greater responsibility. However, these privatizations are not yet in motion.

In terms of financing for the enterprise sector, many new companies that have started up in the last five-seven years are often among the most credit worthy in terms of prospects. New or privatized companies have accounted for half or more of industrial output and transport, and 90 percent or more of construction and trade since 1997-98. Banks have provided more loans to them in recent years, particularly as competition for blue chip customers has been fierce and margins with SME customers are higher. Increased access to bank financing has been evident since late 1995, and lending to SMEs appears to have grown since 1997, although not as quickly as consumer lending. Poland's banks also appear more willing to lend to new firms than their regional peers in Hungary and the Czech Republic.

WSE has also opened additional trading floors since 1997, providing potential financing to about 100 or so SMEs on the parallel and free markets. What has not occurred is meaningful expansion of the over-the-counter market (CeTO), which added only nine companies to its market in the last two years. Over time, a larger number of firms will need to be able to access formal financing, be it from banks, markets or other financing vehicles.

BRE has recently acquired a Vienna-based factoring firm. There is clear interest in leasing. Venture capital is beginning to take hold in Poland. Meanwhile, institutional investors will play a growing role in the coming years as life insurance companies, pension funds, and mutual funds assert themselves as investors in the market.

Meanwhile, state companies still account for a major portion of the blue chip sector. Among Poland's largest 100 companies, 52 are wholly or majority state-owned, down a bit from 60 in 1996. Forty percent of the industrial work force continues to work for SOEs, and more than one third of service sector employment is in Government or for SOEs. However, in one to two years, ownership in several key industries and services will pass on to private ownership on the condition that the fiscal situation has improved, and GoP/Treasury does not hold on to hard to sell firms because of the need for high levels of privatization proceeds to shore up deep fiscal deficits.

Direct bank lending to the state-owned enterprise sector has diminished over the years, and budgetary subsidies have generally declined since the early-mid-1990s as a share of GDP. Meanwhile, Poland has moved ahead with privatization in the power sector, banking, insurance, airlines, petrochemicals, and telecommunications.

Resistance to FDI has diminished significantly since 1996, and Poland attracted more than $13 billion in 1998-99. This made Poland the largest recipient by far among transition countries, accounting for 40 percent of all FDI among non-CIS countries. Among all transition countries, Poland attracted 30 percent of total. Thus, Poland has clearly been the star performer among transition countries in attracting FDI since 1998.

Progress in finishing privatization, along with modernization of agriculture, will be core issues for Poland to meet economic criteria for entry into the EU.

Meanwhile, at the “unregistered” end of the economic spectrum, the EU has applied pressure on Poland to contain open-air market trade due to border crossing requirements. Poland has complied, but this is one of the reasons why export trade with eastern countries has diminished. At end 1997, “unclassified current transactions” were valued at $6 billion, or about 22 percent of registered exports in 1997. By 1999, these transactions had declined to an estimated $3.6 billion, or about 13.5 percent of registered exports, and account for about two thirds of the decline in exports from 1998 to 1999.

2.3 Money, Savings and Credit: Score: 3+	The NBP has pursued a tight monetary policy since the hyperinflationary period in 1989-90. Beginning in 2000, the focus of monetary policy appears to be strictly on price stabilization, with explicit goals of declining inflation rates and the achievement of inflation targets. The move to a fully free-floating exchange rate regime appears to signal a shift in monetary policy following five years in which monetary policy followed a crawling peg. The current approach is intended to increase the sensitivity of firms to price changes in international markets to increase their competitiveness. This is viewed as a necessary step prior to entry into the European Monetary Union (EMU), slated to occur some time in the coming decade. Prior to the current approach, monetary policy focused on gradual devaluation of the exchange rate, a steady decline in the inflation rate as reflected in slowly declining interest rates, and generally tight monetary policy to prevent an "overheating" of the economy. The last point has been in evidence over the years, including recently, when the MPC raised interest rates 450 basis points in total on two separate occasions between November 1999 and February 2000. (It remains to be seen if additional interest rate increases will occur, particularly as the inflation rate remains above target.) Thus, the inflation focus has been a central theme, even during earlier periods of high unemployment. In that sense, movement to a free floating exchange rate and an inflation-targeting approach to monetary policy is not a radical departure from past practices. What is unclear at the moment is if this change signals that the MPC will not engage in costly defenses of the exchange rate in the event of an attack. Under such circumstances, intervention would only be expected if there were a larger threat to overall macroeconomic and financial sector stability. The effects of the earlier crawling peg regime and current floating exchange rate policy have shown benefits since 1995-96. Savings and credit have both increased since 1995. Households are now placing more funds in the banks on a term basis. For example, term deposits now account for 72 percent of total deposits held with banks, as compared with 70 percent in 1998. However, the total value of deposits at end 1999 was only PLN 5,356 per capita, little more than $1,300. Thus, the deposit base remains fairly low in Poland, even if the trend is favorable. Meanwhile, the cost of funds still remains fairly high for banks due to high real interest rates, still inadequate funding from deposits, the concentration of deposits in three banks, and the limited debt market for banks. There has also been some periodic volatility in the interbank market since 1997, most recently from about November 1999-March 2000, the period that coincided with rate hikes. This suggests that many banks remain sensitive to both the supply and pricing of funding due to the limited depth and breadth of the interbank market. For the time being, the challenge to NBP appears to be achieving its inflation targets without causing a major contraction of the economy, withstanding possible attacks on the currency without dedicating hard currency reserves in defense, and reducing the excess liquidity of the banks during a period of declining inflation rates. While CPI measures have increased since August 1999, there is an expectation that the MPC intends to achieve its end

year target of 5.4-6.8 percent. However, with annual inflation measures at 11.6 percent as of mid-2000 and a growing current account deficit, this may be difficult to achieve. Some market participants do not believe the target will be met, and that 7.0-7.5 percent CPI figures are more likely for December 2000. If the target is not met, it will be important to see how the market reacts, and if more restrictive policy will be introduced at a later date.

2.4 Fiscal: Score: 3

Fiscal policy was a cause for concern for the MPC, with considerable concern expressed over prospects for fiscal laxity in 1999. However, particularly on the strength of privatization proceeds, foreign direct investment, improved collections resulting from better administration, and the possibility of growing compliance as tax rates come down, total government deficits in 1998-99 have stayed in the 3-4 percent range. Considering that Poland has introduced significant administrative, health and pension reform over the last 18 months, fiscal deficits could have been more problematic.

One of the main concerns today is the current account deficit and high levels of domestic demand. Should the MPC need to further tighten monetary policy to achieve inflation targets, this could further drive up the mounting unemployment rate. This, in turn, would exacerbate the fiscal situation as collections might decline while benefits claims would increase. Social insurance costs will remain high for the foreseeable future, notwithstanding the important changes introduced in 1999. Meanwhile, despite hard budget constraints imposed over the years on most loss-making enterprises, there is still continued subsidization of some loss-making companies. These subsidies have amounted to about 2-3 percent of GDP per year since 1995. In dollar terms, this would approximate $15 billion since 1995.

Revenues have increased as the economy has expanded, but expenditure has likewise increased. The consolidated deficit was estimated to be 3.8 percent of 1999 GDP. About one-sixth is due to the high social security costs covered by government expenditure, some of which is expected to be less of a burden over time as pension reform translates into lower fiscal costs. However, these payments were only about 8 percent of GDP in 1989, representing an approximate increase from $6.6 billion in 1989 to about $25 billion in 1999. Thus, the implementation of pension reform is one of the most critical items on the Polish fiscal agenda.

Support for loss-making SOEs has diminished over the years, as direct budget subsidies have declined through the 1990s, from 5 percent in 1991 to less than 2.5 percent since 1997. Moreover, banks have steadily reduced their credit exposure to the SOE sector, from 18 percent of GDP in the early 1990s to less than 5 percent of GDP today. Thus, banks have generally provided financing to SOEs on commercial terms and conditions in recent years, and their budget has been more transparent in identifying support for loss-makers (e.g., coal mines) when budgetary support has been provided. Poland's fiscal situation is greatly enhanced by privatization proceeds, and general inflows of foreign investment.

In 2000, privatization proceeds are expected to exceed PLN 20 billion as a result of the privatization of TPSA, KGHM, PZU, crude oil refineries, and other enterprises. Poland also benefits from EU funding, which should help finance some of the local government deficits projected for 2000.

2.5 Exchange Rates: Score: 3+/4-

One of the key policy changes introduced in Poland in 2000 has been movement to a fully free-floating exchange rate. This new approach sends a signal that GoP is confident it has needed foreign exchange reserves to meet external obligations, that monetary and fiscal policy are sufficiently strong to manage domestic requirements, and that the free float is intended to serve as a catalyst for price stabilization at the macroeconomic level and competitiveness at the structural level. The implication of this move is also that the government would not intervene in foreign exchange markets to defend the currency if the exchange rate was under attack. The exception here would be if the attack undermined financial sector stability, at which point open market intervention would be an option.

At the moment, Poland's current account deficit is the most pressing problem, particularly as it has implications for monetary and fiscal policy if it does not come down. Much of the deficit is driven by consumer demand, although some of it may also reflect investment in firms to achieve greater competitiveness, with the benefits to show up in future years in the form of increased export revenues.

As the EU market is the main target for Polish exporters, a freely floating exchange rate may help to keep Polish companies more competitive with other regional firms seeking to penetrate the same markets. This should set in motion a process which will make it easier for Poland to become a member of the EMU, with outright adoption of the free floating Euro. In the meantime, the move to the new exchange rate regime should serve as a stimulus to weed out uncompetitive firms, to reward competitive firms with a growing share of overseas markets, and over time to raise the quality of goods produced and level of services provided to the domestic market.

2.6 Balance of Payments: Score: 3-/3

Poland's balance of payments figures have shown an enormous increase in the current account deficit since 1997, rising from $4.5 billion that year to $11.7 billion in 1999. There has been continued growth in the merchandise trade deficit since 1996. Unclassified current transactions held steady in 1998, but declined significantly in 1999. These two declines reflect a major decline in trade with eastern CIS markets. Non-factor services are also showing some decline due to reduced trade in services and rising debt/interest payments.

The capital account declined by nearly $2 billion after strengthening in 1998. As noted above, Poland experienced a $2 billion net decrease in gross official reserves despite recording high levels of FDI for the second consecutive year. However, FDI and domestic investment are strong, and this should contribute to gross fixed investment and future competitiveness.

Overall, Poland's total public and external debt is managed, and the debt service payments on these debt stocks do not seriously undermine the current account or fiscal resources. However, trends have been unfavorable recently, as debt stock has increased, foreign exchange reserves have decreased, and debt service has contributed to a weakening of the current account.

Consumer demand has been the driving force behind the current account deficit. Movement to a fully free floating exchange rate and a disciplined monetary policy focused on bringing down inflation rates should temper this demand. However, this was not yet evident after the first four months of 2000. The major question regarding Poland's weakened balance of payments profile is whether the high current account deficit reflects investment in future competitiveness, or simple pent-up demand for consumer goods. Direct investment statistics are favorable, and point to retooling in the industrial and services sectors. However, weaker export performance and high levels of personal consumption and consumer goods suggests that households may be on a spending binge, partly due to increased access to bank credit. If so, banks may see a deterioration of loan portfolio quality should the economy slow at some point. This could be direct, in the form of delinquencies and eventual write-offs, as well as in the form of reduced collateral values on exposures to firms engaged in trade. The recent rise in interest rates may reflect MPC concerns about overheating in the economy, particularly to finance consumer goods, and the effect this could have on widening the current account deficit.

Section 3: Assessment of Banking Structure and System Profile

III. Banking Structure and System Profile: Score: 3+

The Polish banking system has been majority private in terms of asset control and equity since 1998. Majority-private banks now account for 72 percent of assets, 74 percent of net loans, 66 percent of deposits, and 79 percent of capital. The privatization of Pekao SA was instrumental in shifting some of these percentages, although private banks have been growing faster in general than public banks. Major Polish banks that are majority private include BRE, PBK, Bank Handlowy (until it is absorbed in some form by Citigroup), and BIG Bank Gdanski. Together, these four banks account for about 22 percent of assets and 14 percent of banking system equity. Meanwhile, state banks now account for about one quarter of most balance sheet measures, down from majority ownership of the banking system as recently as mid-1997.

There has been significant strategic foreign investment in the banking sector since 1998, representing new investment, incremental investment, and consolidation. Citigroup, UniCredito, ING, Allied Irish, ABN Amro, Deutsche Bank, Société Générale, HSBC, BNP Dresdner and Bank Austria Creditanstalt represent some of the major international banks in the Polish marketplace. The recent announcement of the HypoVereinsbank merger with Bank Austria Creditanstalt has major implications for the banking landscape in Poland, as this will over time lead to a merger domestically of PBK and BPH. That Allianz is also a 14 percent shareholder in the newly formed German-Austrian bank may also have an impact over time on the status of Pekao SA, as Allianz is a junior strategic investor in that bank.

There has been a steady harmonization of laws and regulations with international standards to make the environment conducive to ongoing investment, and this has picked up since 1996. More revisions to the legal and regulatory framework are expected by end 2000, driven largely by recommendations from BIS and the Joint Forum on Financial Stability, and the recent demise of a bank and an insurance company.

Balance sheet measures (e.g., capital, liquidity) and quality indicators (e.g., loan portfolio quality) are generally favorable. However, margins have come down in recent years, lending to the consumer sector could raise risks in the event of an economic slowdown, and banks are now beginning to venture into new activities where risk management systems may not be fully developed.

After-tax earnings have declined since 1996, although earnings in 1999 were better than the weak earnings figure registered in 1998, and would have been an extra 13 percent higher had the banking system not absorbed the PLN 470 million loss from Bank Staropolski. After-tax earnings for the banking system were only PLN 1.8 billion in 1998, about $500 million in total, or about $6 million on average per bank. Figures in 1999 were PLN 3.5 billion, or about $880 million in total and

$11 million per bank. ROA figures were 0.67 percent in 1998 and 1.04 percent in 1999. Thus, while 1999 represented an improvement, these are meager figures relative to banks in EU countries. Low returns have largely reflected increasing competition, and significant investment in systems that should generate returns over time. As the market becomes more competitive, governance and management are expected to conform increasingly to higher standards. There is already evidence that this is occurring, although fundamental building blocks, such as the internal audit function, are erratic in terms of performance.

Polish banks have been consolidating since 1997. More recently, Citigroup announced the acquisition of 75 percent of Bank Handlowy, which will create a significant force in the corporate market and, over time, in the retail market. Privatization of remaining state banks is not likely to lead to much further consolidation, as was the case in 1998-99. The only major state banks left are PKO BP and BGZ, which will likely be privatized through shares offered on the WSE.

Foreign banks re-entered the market after 1995, and have played a considerable role in the last two years by adding capital, technology, systems and know-how. In addition to the Citigroup merger with Handlowy, UniCredito of Italy along with Allianz of Germany bought a majority stake in Pekao SA, HypoVereinsbank acquired BPH in Krakow, and Allied Irish acquired Zachodni. Meanwhile, other strategic investors have increased their shares in Polish banks, such as Commerzbank (BRE), Bank Austria Creditanstalt (PBK), and AIB (WBK). The merger of HypoVereinsbank and Bank Austria Creditanstalt will transform BPH and PBK into Poland's second largest bank, and the third largest in central Europe.

More generally, private banks are expanding. Their push appears to be mainly in retail banking to diversify income sources, to attract more stable funding sources, to market non-bank financial services, and to avoid the low-margin corporate business that now appears to be dominated by a few major banks. The last tendency was brought on by the narrowing of margins on exposures to blue chip customers, a trend that was already in evidence in 1997. The limited after-tax earnings in the banking system in 1998 partly reflected these trends, and some banks have shifted their focus as a result. The risk is that many banks may be willing to take on more risk to generate higher earnings, particularly as the earnings profile of most banks has been relatively weak since 1997. Many banks are now providing consumer loans for auto and appliance purchases, loans against receivables from leasing companies for asset-based lending, and overdraft facilities for customers with "plastic cards." There is also the risk that banks will seek to improve earnings performance off of higher interest rates at the risk of suffering higher levels of default by lending to borrowers that are unable to manage their finances properly during a period of rising interest rates and more volatile exchange rates.

Meanwhile, the cost of funds has declined since 1997, although

	recent rate hikes have led to an increase in deposit rates. However, the series of rate hikes from NBP have permitted banks to raise interest rates on loans. Currently, net spreads on loans are reported to have increased about 100 basis points in the last half-year or so. Thus, net interest margins may begin to show increases and boost bank earnings. **While banks are reported to enjoy excess liquidity, the deposit base is still relatively small, corporate issues in Poland are limited, and syndicated borrowings from external sources represent a major supplement to Poland-supplied resources. Deposits also remain concentrated in PKO BP, Pekao SA and BGZ (and, more recently, with PBK, BPH and Bank Slaski), which makes the inter-bank market sensitive to the financial condition of these banks. In the case of Pekao SA, the failure of Bank Staropolski reduced after-tax profits by about PLN 90 million. Therefore, events such as these can have an important impact on inter-bank financing.** **Meanwhile, capital at most banks is still low by global standards, although recent consolidation has helped to increase average bank capital. Nonetheless, the entire funding side of the banking system still remains small in Poland, even if it has grown over the last two years.**
3.1 Overview: Score: 3/3+	Poland's banking system is becoming increasingly competitive now that Poland has opened up the banking sector to strategic prime-rated investors. While the market has been open for years, strategic investment has intensified in the last two years. Prior to this period, NBP appeared a bit more cautious in its approach, geared more towards domestically-oriented consolidation. However, recognizing the need for new capital and systems that would make Polish banks more competitive *and* compatible with EU banks and banking systems and, by extension, global standards, NBP has sent signals to international markets that it supports the entry of investment-grade foreign institutions into its banking sector. At end 1999, foreign institutions accounted for 56 percent of banking sector equity. This, along with investment in information systems and the shift towards consumer banking, is the most salient change in the Polish banking landscape since 1997. Banks have shown progress in management and governance based on BIS guidelines for prudential regulations, international standards of accounting, and earlier restructuring efforts. NBP regulatory oversight has played a constructive role in helping to monitor for bank risks, and to serve as an incentive for banks to develop risk management systems. Recent strategic investment should help with expansion of risk management capacity, so essential as banks push into non-banking activities. Lending flows began to increase in late 1995 as net spreads on securities began to decline, and as banks reached levels of capital adequacy on a risk-weighted basis that permitted them to resume lending. More recently, and since 1997, there has been considerable evidence of increased lending to households, individuals, and small businesses. Overall, balance sheet indicators indicate some decline in asset quality, with

the ratio of irregular classifications to gross claims rising from about 10.5 percent in 1997-98 to 13 percent by end 1999. Commercial banks in particular showed an increase, with 13.4 percent at end 1999 (as compared with cooperative banks, which only showed 3.6 percent at year end 1999, about the 1997-98 average). There are some concerns about the risks associated with the substantial increase in consumer and small business lending—much of it installment finance. All of these trends are further compounded by the risk of higher inflation rates, which may prompt further interest rate increases, and set in motion a higher level of default that would then trigger higher levels of irregular loans. However, these risks have been a concern since 1996, and are mitigated by the requirement that banks fully provision for these losses and risks.

Polish banks appear to be diversifying, irrespective of ownership. Polish banks have sought to expand their retail operations, recognizing the importance of deposits as a reliable source of funding and, until recently, the small portion of their earnings that comes from fee-generating services. This has inevitably led to more consumer services, particularly as new information systems have been brought on stream.

Meanwhile, foreign-controlled banks have been increasing their balance sheet exposure—lending and retail services—now that the blue chip market is saturated, and rates for a range of services have come down. For instance, foreign banks are now responsible for 51 percent of net loans, as compared with 22 percent in 1998. While this is partly due to the privatization of Pekao SA, it is also due to a general increase in lending by banks, Polish and foreign.

After-tax 1999 earnings showed that cost structures remain high—costs were 93 percent of gross income, up from 85 percent in 1997. State banks' cost-income ratios were 92.4 percent, while private Polish banks showed 88.4 percent, foreign-owned banks showed 95.0 percent, and cooperative banks showed 87.6 percent. Thus, the high ratios appeared to be driven primarily by expansion plans and investment in personnel and systems by foreign banks. Poland's 16 listed banks showed cost-income ratios of 92.2 percent. Return on assets and equity both increased in 1999, but this was mainly due to the low returns in 1998. For the system as a whole, NBP figures for 1999 show ROA at 1.0 percent and ROE at 14.2 percent. While higher than figures in 1998, they are considerably lower than 2.0 percent ROA and 24.7 percent ROE in real terms for 1997, and 2.5 percent and 41.9 percent, respectively, in 1996.

Now that corporate sector competition is strong, the next trends appear to be intensifying competition at the retail level, and the provision of a wider range of services that cut across financial services markets (by product and region). Upcoming challenges at the *system level* include the ability to identify and contain risks as banks venture into new and riskier activities, strengthening coordination at the technical level among various regulatory authorities in concert with the Committee for Banking Supervision, the outcome of consolidation in the coming years, the method and result of privatization of BGZ and PKO BP (particularly from the funding side), the potential for other bank failures as a result of poor information and questionable cross-border transactions, and the role of the judiciary in settling disputes in a timely fashion

	that also reinforces incentives for prudent management of credit. At the *firm level*, key risks for banks and financial services companies include development of autonomous internal audit functions and enhanced internal controls for strengthened governance and oversight of management, the expansion of risk management capacity as banks increase their presence in a variety of financial services, the success of investment in management information systems that produce needed information in a timely manner for management to identify and contain risks as they surface, the strategic direction of various banking firms under open and highly competitive conditions, and the synergies achieved from investment in non-bank services with banking franchises. Many of these challenges existed two years ago, and will be ongoing. The presence of major global players in the Polish market helps with many of these risks. It is expected that the more successful foreign banks will succeed because they will have formed more fruitful partnerships with local Polish institutions, thus achieving a more accurate reading of the local market. It remains to be seen how long the major Polish institutions will be able to compete with global power houses in the absence of further consolidation or strategic investment. Trends point to these firms increasing strategic investment, although this approach has initially been ruled out for PKO BP. The impact of consolidation will also have a direct impact on the Polish banking landscape, with Citigroup and HypoVereinsbank-Bank Austria possibly representing driving forces in the coming years.
3.2 Ownership: Score: 3+/4-	Poland's banking sector has gone through rapid transformation of its ownership figures in recent years. In early 1997, banking was still primarily driven by state/Treasury-owned banks, although liberalization and rising interest from foreign banks were materializing. Today, banking is dominated by 16 listed banks (of which 15 are private), of which about half have foreign investment, and several large unlisted foreign banks that are competing in the corporate and retail markets. The combination of listed and foreign banks is also heavily involved in non-bank activities, with primary shares in brokerage, insurance and pension funds. Apart from the prominent role of PKO BP and BGZ in deposit mobilization, banking is now largely driven by the private sector. Past reticence on the part of NBP and GoP to accelerate privatization via strategic investment has given way in the last two years to major investment from prime-rated foreign institutions. While political considerations will undoubtedly affect the type of privatization method ultimately used for PKO BP and BGZ, the focus today is primarily on increasing capital, providing world class financial services, demonstrating progress towards meeting EU and EMU standards, and conducting financial sector activities in a safe, sound and stable manner. Private banks are now responsible for 79 percent of the total capital base of the banking system (as of end 1999), of which 50 percent is with majority-foreign banks. Public attitudes have changed favorably about banking and banks in recent years, resulting from improved levels of service, greater access on the part of small businesses and individuals to credit, and obvious

	commitment on the part of investors to building retail operations. This should not be interpreted as full proof with regard to risk and stability. However, banking has evolved in Poland as a fundamentally sound and competitive sector of the economy.
3.3 Governance and Management: Score: 3+	Governance in Poland has been reasonably strong and/or improving for many years. The process began in 1992-93 when hard budget constraints were imposed, twinning arrangements were introduced, portfolio restructuring efforts began, banking supervision began its institutional development process, and banks started to effectively recapitalize. More recently, efforts have been made to address weaknesses at the supervisory and management board level. This has come from prodding by the GINB, coordination with the CBS (via the Polish Banking Association), broader acceptance of the need for strong risk management systems after the Russia/East Asia/emerging markets turbulence of 1997-98, and significant increases in foreign investment. Bank Handlowy and BRE were both considered to have sound reputations for governance and management in 1997. Other Polish banks had varying reputations, but were considered less strong than these two banks. In particular, while several banks improved their balance sheet management during the mid-1990s, there were doubts about governance and management capacity for risks in a universal banking regime under competitive, open market conditions. For instance, banks showed greater prudence in credit management, but this was more in the form of conservative judgments and heavy collateralization coming off a period of high levels of Government securities investment. Banks did not necessarily have adequate systems in place for unsecured lending, foreign exchange trading, or other risks that could surface. Nor were banks focused on improving service levels and introducing a wide array of retail services. This has clearly changed in the last two years, with competition evident in the corporate and retail markets. However, there still appear to be potential weaknesses at many banks. The internal audit function is not as autonomous or developed as it needs to be at many banks. Internal controls are not always in place. There are reported to be high levels of unhedged exposures. Lending to the consumer sector has sometimes relied on third parties and credit agencies. There are dubious forms of cross-ownership that raise questions about the potential for losses to the system, as occurred with Staropolski. More generally, given that the economy has shown real annual growth 4-7 percent since 1994, there is also the possibility that some portfolios are vulnerable to broader economic decline, and that the strong economy has obfuscated some of the underlying weaknesses of portfolios. Further, while Staropolski was not bailed out, there are questions about the role of the Bank Guaranty Fund's assistance fund, the potential for forbearance and lender of last resort financing to large banks that may not always be as soundly managed and supervised by the boards as needed, and the signals these send with regard to incentives for strong corporate governance. Poland was reputed to have supervisory board weaknesses in 1997-98—an absence of experienced financial sector personnel to provide needed

	oversight—and associated internal audit weaknesses. While supervisory boards are now stronger, GINB has cited the need for a strengthened and autonomous internal audit function at many banks. This would require greater separation of functions, better information systems and internal controls, better compensation for internal auditors, and reasonable protection for internal auditors when informing the supervisory board of unwelcome findings and advice. Some of these measures have been put in place in recent years, but GINB believes performance at banks is erratic. As the market has become more competitive, the onus is shifting increasingly to boards to ensure their management teams have devised and are implementing appropriate strategic plans with corresponding risk tolerance levels to the various activities that are part of that strategy. This requires financial, legal, technical and business skills to comprehend the growing complexities of risks the banks will soon face with universal banking in place and integration with the EU intensifying. Management will need to ensure the personnel, systems and procedures are in place to implement their strategies, and to identify, contain and communicate unanticipated risks when they materialize. There is strong evidence that foreign banks have these systems in place, and that the larger Polish banks generally do so as well. To the extent that the state/Treasury-owned banks may have weaknesses, their financial results in the last year or so seem to indicate they are pursuing a relatively cautious approach to asset management so as to not undermine deposit safety. Poland's banks have generally shown progress over the years. This has been most noteworthy in terms of the financial and operational restructuring of most state-owned banks since serious reforms began in 1993.
3.4 Non-Bank Competition: Score: 3	The non-bank sector is beginning to expand in some areas, and to consolidate in others. Growth is steady but plodding in the capital markets and insurance sectors. The recent introduction of pension reform should serve as a spur for both, with insurance companies playing a major role in the pension fund business, and 30 percent of proceeds being invested in WSE equities. In other cases, there has been slow progress—notably with the privatization of PZU in insurance, and development of the leasing sector—or growth of consumer and commercial finance companies that can pose a problem to the banking sector if not properly overseen. At the small-scale level, credit unions have formed in many Polish cities and towns, serving as a provider of financial services to many people who earlier were unable to access banking services. The cooperative banks' financial condition appears to have stabilized for the time being. Progress appears to have slowed on a number of fronts since 1997-98. While the PZU privatization is moving forward, the pace is slower than originally anticipated. A new framework for leasing was in process to reconcile tax incentives with international standards, and to design an improved accounting framework for leasing (which the Accounting Act does not cover). These are more likely to materialize later in 2000 with a new framework, but little has occurred since 1997.

A legal framework was being put in place for mortgage banking, which will allow for the trading of mortgage bonds. However, time is still required to strengthen market mechanisms for credit risk evaluation and collection. This market is expected to show high levels of growth in the coming years.

It is expected that over time, there will be significant growth in most "non-bank" services, and significant cross-ownership among financial services companies. This will require better coordination among the regulatory authorities of the BSC at the technical level to avert systemic risk and the spillover effects of mismanagement, weak audit and accounting standards, and other forms of potential misrepresentation among non-banks that could adversely impact banks and public confidence.

Section 4: Assessment of Banking Sector Development Based on Prudential Norms

IV. Banking Sector Development Based on Prudential Norms: Score: 3+

The Polish banking system's basic financial indicators—capital adequacy, asset quality, increasing liquidity—have changed little since 1997-98, which is both positive and negative. On the positive side, it reflects underlying stability and measured growth during a period in which there was significant turbulence in emerging markets, and in which international trade was partly set back due to weakness in eastern countries and slower than expected growth in the EU. While there has been an increase in irregular loans, the general trend has been towards a deeper funding base, strengthened capital, significant investment in systems, expansion of meaningful retail banking, marked competitiveness in the corporate lending market, and enhanced management and governance resulting from years of effort, legal and regulatory incentives, and recent strategic investment. All of this has benefited from a disciplined monetary policy that remains focused on reducing inflation and interest rates to EU/EMU standards, notwithstanding recent setbacks.

On the negative side, cost-income ratios are high, net margins are low, assets/GDP and intermediation levels are still relatively low, ROA and ROE have been unimpressive, there remains severe concentration in the deposit market (adding sensitivity and risk in the inter-bank market), and there is continued state ownership in two major banks. However, several negatives have positive components within them. While cost-income ratios are high, some of this reflects investment in systems and training of increasingly well paid personnel, both of which will generate favorable returns in the future.

Intermediation rates are still not at OECD levels, but they have been rising over the years. This trend is expected to intensify in the coming years with more account holders linked to the banking system, banks learning how to better manage credit, and rising incomes creating additional opportunities for both secured and unsecured lending. Lower margins, ROA and ROE reflect high and increasing levels of competition, which is driving banks to improve service levels and to lend more to the SME and household sector. This competition is also reducing the concentration of deposits, particularly as private banks expand their ATM networks and move to "brick and click" approaches to consumer banking.

Even the state/Treasury ownership of PKO BP and, eventually, BGZ will be coming to a close. There have already been preliminary announcements that PKO BP will be privatized through an IPO. This will more than likely lead to a broad giveaway to numerous stakeholders, with management eventually consolidating shares and possibly attracting strategic investment over time. However, it is a step forward, ultimately moving Poland even closer to a fully privately-

owned banking sector.

From a supervisory standpoint, NBP/GINB have done a good job in moving Polish banking towards BIS/OECD standards and preparing for EU/EMU entry. Weakness in this domain is in the absence of coordination across financial services (i.e., banking, insurance, securities) at technical levels, notwithstanding coordination that does exist via CBS between banking and securities markets. It is recommended that Poland establish working groups across financial services, and that amendments to laws and regulations focus on integrated, risk-based supervision on a consolidated basis. Considering the distribution of ownership in the banking system (and other financial services), it would be helpful as well if EU and US regulatory officials would show a willingness to formalize cross-border coordination efforts, although this might be something that could be exercised through BIS. (To date, many of these arrangements have been informal and *ad hoc*.)

Clarification of cross-ownership rights and responsibilities, tougher sanctions against imprudent behavior, and better cross-border coordination are all needed for Poland to properly protect itself against extraordinary financial sector risks that could cause instability, undermine confidence, and weaken implementation of monetary policy. The legal framework also needs to be accompanied by more advanced levels of judicial reform, building on recent improvements in the registration and perfection of liens. Disputes are still time-consuming, costly, and subject to the judgments of some personnel who are not always as skillfully trained in commercial law and practices as needed for a modern market economy.

Overall, Poland's biggest achievements over the last two years appear to have been overcoming fears of competition from large foreign banks, and narrowing the electronic and systems gaps that were fairly wide two years ago. Privatization and strategic investment have been drivers in both these areas. GoP is also to be commended over the last two years in moving forward with key privatizations—Pekao SA, BPH, Zachodni—and providing incentives for modernization and use of electronic transactions.

Poland has generally demonstrated favorable trends in the last several years. Capital adequacy ratios are sound according to BIS guidelines, with the average value of risk-based capital at 13.2 percent at end 1999, and 69 of 77 banks having risk-adjusted capital in excess of 8 percent. Asset quality has been maintained, with only a slight increase in the percentage of irregular loans.

Attention needs to remain focused on the risks associated with consumer lending/installment financing activities, and in third party transactions involving loans and guarantees. As these are the fastest growing areas of activity, there is also a possibility that banks are assuming excess risk due to pressure on margins from other types of lending. The potential for increased levels of default and non-performance in banks' loan portfolios are real risks in the existing

environment characterized by higher inflation rates, and the chance that MPC may introduce yet higher interest rates to curtail rising inflation rates. GINB is aware of these potential risks, and banks are required to provision fully for risks in these areas of lending.

Earnings have been relatively weak over the last two years, and on average about half the earnings achieved in 1996-97. Last year's performance of PLN 3.5 billion ($880 million) was better than 1998, but only about two thirds earnings in 1996-97.

Funding is still subject to the predominance of deposits, although NBP's reduction of reserve requirements had a net favorable impact on available resources for lending. Recent rate hikes appear to have increased the net spreads for banks by about 100 basis points. Deposit mobilization has improved, partly reflecting the rising real incomes of households, and their interest in some of the term deposits offered by the banking system. Term deposits are now 72 percent of total, up from 70 percent two years ago and perpetuating positive developments in this area. There has been a major increase in the number of bank accounts opened in recent years, and public confidence appears high and increasingly favorable. However, there is still significant concentration in the holding of deposits, with three banks accounting for about half of total deposits. This concentration continues to subject the inter-bank market to high levels of sensitivity to the financial condition and liquidity needs of these three banks. Moreover, major deposit-taking institutions not receiving assistance from the BGF (i.e., Pekao SA) are highly sensitive to bank failures, as the current formula for coverage of the net financial loss of a bankruptcy is pro-rated based on shares of deposits held. While this provides an incentive for banks to police other banks, it appears to penalize banks that have been successful in mobilizing deposits irrespective of their own prudence.

The interbank markets function reasonably well, accounting for about 17 percent of total liabilities and capital. However, these markets are still relatively thin and, as noted, subject to the availability of resources from three major deposit-takers. In the absence of a developed corporate bond market, banks continue to draw on syndicated loans for term financing. With consolidation, this should increase over time. However, consolidation may also imperil the availability of resources from banks for large borrowers due to concentration/exposure ratios. Thus, consolidation may also hasten disintermediation, as companies go directly to the markets for future financing if they are unable to access credit from banks.

WSE is still heavily weighted towards banks—banks account for 28 percent market capitalization, down from 33 percent in 1997 but up from 21 percent at end 1996—and this provides further incentives for prudent management for performance and growth. Proof has been in the increased strategic investment in banks in the last two years, including the listed banks. However, given narrowing margins in recent years and intensification of competition, there will be temptations to

take on high levels of risk. About half of off-balance sheet activities are related to foreign exchange trading. This may be an area in which to focus for risk, as should the high levels of foreign exchange exposure of the corporate sector that remain unhedged. While this may not be a direct risk to banks, major losses by borrowers could ultimately challenge cash flow and the ability of customers to service/repay their obligations.

It is unclear how detailed by currency and maturity the information NBP/GINB have, or the degree to which banks themselves are monitoring for these risks. The larger foreign and listed banks do this as part of their routine risk management. However, it is not clear that NBP/GINB have contingency plans for stress test scenarios in which major institutions' losses could jeopardize financial sector stability. All that is known is that NBP is willing to intervene in foreign exchange markets if there is a risk of instability. In general, boards and management will need to exercise prudence and caution to avert such scenarios. Better MIS and use of these systems, and a strengthening of internal audit capacity *and* autonomy will help in this regard.

Key questions for the Polish banking sector in the coming years will be (i) the pace and method of privatization of PKO BP and BGZ; (ii) the pace of consolidation in financial services, including the impact of these factors in the insurance sector with regard to cross-ownership, securities markets, and other major financial services; (iii) the impact of consolidation on lending to the real sector, with the possibility that at some juncture, fewer and larger banks might not be willing or able to provide enough resources to meet household/SME credit demand without the development of secondary markets or syndications; (iv) the ability to raise capital and intermediation levels to a point needed for competitiveness by global/EU standards; (v) risk management capacity, as bank asset structures grow and take on more and diverse risks under open market conditions that reflect intensified competition; (vi) the sustainability of earnings as banks adjust their risk tolerances and venture into activities in which they have limited albeit growing experience—Polish banks from a product standpoint, and foreign banks from a local market standpoint; (vii) the ability to manage credit risk and absorb losses as banks vie for non-blue chip business, extend credit for longer periods, provide loans with differing interest rate and currency features, and eventually show a larger proportion of unsecured loans; (viii) the willingness of mid-sized Polish companies to adapt to international standards of transparency and disclosure to obtain added financing, particularly as many companies still conceal information from fiscal authorities and their bankers; (ix) the degree to which regulatory authorities will be able to coordinate their supervisory activities in support of safety and soundness, and general financial sector stability, both within Poland and on a cross-border basis; (x) the ability of regulatory authorities to monitor for more "exotic" risks—off-balance sheet items, derivatives—and to contain those risks when

adverse effects occur; (xi) the willingness of corporate customers to hedge their risks, and the ability of the market and supervisory authorities to monitor for risks that could cause instability in the markets; and, at some juncture, (xii) the ability of the banking system to weather a downturn in the economy after several years of rapid growth, which might lead to an unmasking of competitive weaknesses in companies that have positive financial results as long as the economy is growing.

Poland has continued to make progress over the last several years as it moves on towards integration with the European Union and plays more of a role in other international organizations (e.g., BIS regional fora, OECD). Poland's significantly greater investment and improved management systems in recent years have strengthened the financial services sector and moved Poland closer to competitive standards.

4.1 Capital Adequacy: Score: 3

Poland's banks are adequately capitalized by risk based on BIS standards, with improvement in 1999 after a decline in 1998. Capital adequacy ratios showed a mean value of risk-based capital at 13.2 percent at end 1999, with 69 of 77 banks having risk-adjusted capital in excess of 8 percent. However, many of Poland's private banks remain relatively small in terms of average and total capital—average capital of Poland's private banks was equivalent to Euro 14.9 million at year end, but 8 of those banks had average capital of Euro 31 million. This left a balance of 23 private Polish banks with average capital of Euro 9.3 million, compared to the EU minimum of Euro 5 million. However, in recent years, banks have generally increased their capital. Reaching EU minimum levels was required by NBP/GINB by 1999.

Total capital in banks was PLN 31 billion at end 1999, or about $8 billion. This compares with PLN 21 billion at end 1997, or about $6 billion. On a risk-adjusted basis, banking system capital was PLN 25.8 billion, or about $6.5 billion, as compared with PLN 17.9 billion, or $5.1 billion, at end 1997. Netting out cooperative banks from the total, this amounts to about $80 million per bank at end 1999, compared with $60 million per bank at end 1997. According to NBP, 55 banks had risk-based capital ratios in excess of 12 percent, and 69 were at or above 8 percent. Only eight banks were below 8 percent, although five had negative net capital on a risk-adjusted basis. These and three others are presumably implementing corrective actions.

Capital ratios increased notwithstanding the reduced share of government securities investments (with zero risk weights). For listed banks, WSE share prices remain attractive and the market is liquid, thus providing capital strength and needed financing. Thus, capital for the sector appears adequate. However, many of the private Polish banks and five of the seven Treasury-owned banks are small and will not likely be able to compete without mergers with other institutions. In some cases, this may not be needed as several licensed banks are actually auto finance companies. However, there are many smaller Polish banks that seem unlikely to survive competition with low levels of aggregate capital and aggressive competition for retail markets.

Moving forward, privatization of PKO BP and BGZ are likely to be carried out through IPOs on the WSE (and possibly other exchanges) rather than through strategic sales. Incremental capital may be brought into the system as portfolio money may be invested in these banks through the Exchange. However, for now, it looks as if incremental capital would only come from new purchases (e.g., Deutsche Bank pursuing another Polish bank), increased investment from foreign banks that wish to increase their stakes, and retained earnings.

High levels of capital adequacy will require that (i) assets be properly managed, (ii) banks expand earnings from off balance sheet activities, (iii) investments generate higher returns than in recent years, (iv) high cost-income ratios come down, (v) non-bank activities do not generate harmful losses to the consolidated operation, and (vi) earnings are ploughed back into the banks' operations so as to build critical mass. As of end 1999, CARs were satisfactory.

4.2 Asset Quality: Score: 3/3+

Asset quality appears to be satisfactory, as evidenced by the favorable share prices of listed banks, the high level of investment into the sector, improving risk management systems at the banks, better governance and management (partly based on regulatory signals and incentives), and high levels of real economic growth since 1994. However, irregular loans have increased in the last two years, reflecting additional risks that banks have taken on to increase margins.

There are lingering questions about underlying quality of assets in the event of an economic downturn, and of the possible misrepresentation of asset values and portfolio performance in some of the smaller banks that may not be employing adequately trained audit firms. Some of the risks include assets that are overvalued due to generous assumptions regarding collateral or real estate values, incomplete reporting of related-party transactions, exchange rate risk associated with some assets/exposures, and unhedged positions in the corporate sector that could jeopardize bank portfolio quality should there be unfavorable movements. In terms of assets, some of the lending provided by banks is secured by intermediaries' receivables that are themselves secured by assets. Such asset values, as well as recovery rates on receivables, could decline in the event of an economic downturn. Likewise, fixed assets are often more of a headache as collateral than basic inventories on simpler operations, as found in exposures to the leasing market.

Relatively weak ROA over the last two years also points to issues that touch on vulnerabilities in both earnings and assets. Loan portfolios to enterprises and households account for 44 percent of assets (end 1999), up from 40 percent two years earlier. Incremental growth in bank assets since 1995 has been from new lending flows. This has proceeded steadily as inflation rates have come down, fiscal deficit financing needs have diminished, net spreads on securities have decreased (justifying the risk of increased lending), and banks have become more comfortable lending to consumers.

Throughout the system, the trend towards increasing consumer loans needs to be monitored, both in terms of underlying quality as well as off-balance sheet risk in the event of an economic downturn. There are asset-based and pricing-related risks for banks to be mindful of, as well as broader market risks. In some cases, the source of funding for these loans is thought to be foreign currency-denominated, which is then lent in zloty at higher rates. Thus, there may be some exchange rate and interest rate risk associated with such lending patterns, particularly if exposures are unhedged (particularly given the recent shift to a fully floating exchange rate).

NBP/GINB has been aware of foreign currency risks over the last few years, and provisioning requirements are strict in this area for banks. However, published NBP reports do not break down foreign currency exposures on a weighted time-to-maturity basis. Poland's comparatively high interest rate environment also presents risks to underlying asset quality, even though interest rates have come down over the years. In the past, asset quality was bolstered by the limited term exposure of most portfolios, and prudent matching of assets and liabilities. However, these risks are likely to increase over time as the real sector seeks long-term loans.

Risks to identify could come in the form of fixed vs. variable loans, or imprudent maturities relative to funding. The mix of exchange rate and interest rate risks will need to get attention given the fully free floating exchange rate and liberalized capital controls. The recent rise in inflation rates and interest rates illustrate these risks need to be actively managed and anticipated. NBP is thought to be fully mindful of these risks from a monetary standpoint, and GINB is aware of these risks from an institutional perspective. In both cases, there is a clear understanding of the link between tighter monetary policy, higher interest rates, the risk of default on debt obligations at the firm level, and the impact this would have on asset quality and earnings in the banking sector. These are clear topics for coordination at technical levels via CBS between GINB and the Securities Commission.

Otherwise, government securities still represent a significant portion of the balance sheet—24.5 percent of total assets—net of what is owed by the central bank as part of reserve requirements. Lending to the interbank market is considered safe, accounting for about 16 percent of assets. Fixed and other assets represent 15 percent of total. About 8 percent of assets are held at the NBP in the form of cash and securities. Thus, the main underlying questions regarding asset quality are (i) risks associated with the loan portfolio, particularly consumer loans and associated interest rate and exchange rate risks, as well as guarantees, collateral and other off-balance sheet items associated with lending; (ii) the safety of interbank lending; (iii) the quality of investments in non-government securities; and (iv) the quality of fixed and other assets.

4.3 Management: Score: 3+

Bank management was improving in Poland in 1997, and intensified competition and strategic investment have perpetuated this trend. Investment in information, systems and personnel in recent years has helped with the level of professionalism in bank management. However, in some cases, boards are apparently composed of people lacking in qualifications suited to governance responsibilities. Weaknesses of the internal audit function and internal controls are also reported to be a problem in some banks.

In terms of management, the high staffing levels appear to reflect weaknesses at many banks at the middle management level due to job protection. As an example, UniCredito agreed to retain high levels of staffing for a period of two years as a condition of its acquisition of Pekao SA. However, this is more than a numbers issue, as overall employment in financial services has grown. The key issue is the efficiency of personnel and their skills suitability under competitive conditions. Personnel expenses have risen at the banks for several years, partly driven by rising compensation and partly by (re)training. However, in some banks, mid-level managers have been protected, and this represents a cost to those institutions that undermines their competitiveness and efficiency.

Banks have utilized information generated for NBP/GINB as part of their larger effort to strengthen MIS and to develop better risk management systems. Management of credit appears to be satisfactory and prudent, notwithstanding the rise in irregular loans over the last two years. However, questions remain about off-balance sheet exposures and risks taken in foreign exchange markets, the quality of collateral, and the potential impact of an economic downturn on portfolio quality. Banks with exposure to Russia were hurt in 1998. Since then, banks have been under pressure to strengthen internal systems and to better monitor exposures and associated risks. This is particularly important with regard to consumer lending due to fast growth in this market.

Corporate exposures to the real sector also need better management, as the share of irregular loans in this category increased significantly in 1999 to 15.4 percent, as compared with 11.9 percent at end 1998. Given that 1999 was a better year for Polish banks, these irregulars may reflect worsening cash flow in the corporate sector. For banks, this is of critical importance because corporates accounted for 77 percent of total claims of banks on loans to companies and individuals, and 89 percent of total irregular loans. In particular, figures in 1999 indicate that these problems were more severe for majority Polish banks in both zloty and foreign currency loans. Foreign banks also showed a rising trend of irregular loans made in foreign currency, although zloty loans showed improvement in quality. The ability to manage these risks will go a long way in determining the future course of earnings, growth and stability in the banking sector, particularly at the largest banks.

Liquidity management appears adequate, as most banks appear to follow prudent asset-liability management practices. However, as shown in the decline in quality on foreign currency loans in 1999, banks may need to strengthen capacity to manage exchange rate risk. This is all the more important as Poland has moved to a fully free floating exchange rate, and as banks are showing growth in off-balance sheet foreign exchange trading.

Meanwhile, banks may also have to strengthen their capacity to manage interest rate risk, as MPC has demonstrated its willingness to hike rates significantly to control inflation. The influx of portfolio funds, and the potential for a rapid withdrawal, also adds to both interest rate and exchange rate risk for banks that will need to be managed. Weaknesses in the management of exchange rate, interest rate and pricing risk may surface as banks search for ways to increase earnings under more competitive market conditions. Banks, investors in banks, and NBP/GINB will need to monitor these risks to avoid unanticipated losses that could impair capital. Coordination with the Securities Commission is of vital importance in this domain, as banks account for nearly 30 percent of WSE market capitalization and turnover.

To date, Polish banks have generally followed conservative practices to avoid the transactions costs of increased hedging risks. Banks may be willing to incur these costs in the future, and if so, they and those responsible for oversight will need to be certain that hedging strategies are prudent and do not subject the banks/financial sector to dangerous risks.

Banks have been investing in systems and personnel in recent years to ensure they have suitable risk management systems in place. Strategic investment in many banks has helped in the last two years.

4.4 Earnings: Score: 3-

After-tax earnings increased in 1999 after a poor year in 1998. However, earnings are lower than in 1996-97. On a dollar basis, after-tax earnings were about $880 million in 1999 against an average $1.5 billion in 1996-97. On a bank-by-bank basis, average profit was about $12 million and ROA was 1 percent, compared with $17 million per bank and 2 percent ROA in 1997.

Earnings have been declining for years due to pressure on margins in the corporate sector, reduced net spreads on investments in government securities, and higher cost ratios. Reduced spreads in the corporate sector are largely due to increasing competition, which is also partly due to the second factor of reduced net spreads from securities investments.

As foreign investment has increased dramatically since 1998, the government's need for bank financing has diminished. This trend had already begun in 1996-97 with economic growth, increased revenue collections, and stabilized levels of deficit financing. Reduced government demand for bank financing led to lower earnings from these investments for banks, prompting banks to seek out new financing activities. With the blue chip market saturated and the banking sector becoming more competitive, banks have shown increasing willingness to lend to the consumer market, mainly for installment financing for vehicles.

Meanwhile, there has been further pressure on earnings due to costs. Cost to income ratios were about 93 percent in 1999, up significantly from 85 percent in 1997 and 81 percent in 1996. Ratios were particularly high at foreign banks (i.e., 95 percent), the assumption here being that UniCredito is investing heavily in Pekao SA, and other foreign banks are tooling up to capture more of the retail market. Private Polish banks' ratios were lower than the public sector banks. In general, cost-income ratios were high due to overhead costs at PKO BP, BGZ and Pekao SA, and higher personnel compensation and provisions at all banks.

At the state/Treasury-owned banks and Pekao SA, head count is high, and there are questions about productivity. Majority-owned Polish banks had 86,199 employees at end 1999, as compared with 63,439 at the foreign-owned firms. This reflects a more manual orientation to retail banking among the majority Polish banks, as evidenced in the numbers of branches and other offices—

1,243 branches and 6,939 offices at Polish banks, compared with 992 branches and only 1,048 other offices among foreign banks. Given the Pekao SA has about 40,000-45,000 in staff and 700 branches/offices, the other foreign banks appear to be much leaner operations, and far more profitable on a per-employee basis.

4.5 Liquidity: Score: 3-/3

It is the position of MPC that the banks have excess liquidity. Movement to a freely convertible exchange rate and greater reliance on open market operations is expected to reduce growth in official reserves, and allow a more market-based determination of pricing for banks' borrowings from NBP and the inter-bank market.

Funding is slowly improving in the aggregate due to more bank accounts, and the willingness of households to increase their term deposits. Meanwhile, a decline in reserve requirements provided banks with more resources for lending in 1999. However, structural funding weaknesses remain due to the concentration of deposits in three banks, the thin corporate bond market, and low capital. While term deposits and bank capital increased in 1998-99, it will still take time for Poland to narrow the gap with EU banks in terms of size and intermediation resources.

The inflation rate has been increasing since August 1999, consequently pushing the MPC to raise interest rates twice. This has pushed up rates 450 basis points, although it may also help bank margins.

The secondary markets are still weak for securities, which means banks have to rely on real sector deposits for about 62 percent of overall funding and the interbank market for another 17 percent. Meanwhile, PKO BP, Pekao SA and BGZ account for about half of total deposits. Thus, most other Polish banks have weak funding bases, although the listed banks are able to obtain WSE financing and syndicated loans from abroad. While the interbank market is relatively safe and meets some financing needs, rates showed some volatility during late 1999-2000 when interest rates were being raised.

Bank liquidity is expected to benefit from recent improvements in the payment system. Meanwhile, higher capital among the larger banks and access to banking and capital markets abroad should be able to provide needed financing should deposits, inter-bank sources, and domestic debt issues not cover banks' financing needs.

4.6 Operating Environment: Score: 3+

Poland's banking system enjoys increasingly high levels of public confidence. While intermediation rates may still be lower than in some of the neighboring countries—and well below OECD and EU norms—deposit mobilization has been increasing steadily and in absolute terms, as well as proportionally as a percentage of money supply and GDP. One indication of growing confidence has been the increasing share of deposits held with banks that are term deposits, a trend that began a few years ago. This partly explains the lack of alternatives for Polish savers, although pension reform and growth of the life insurance market is changing the landscape while banks compete to build their funding bases. These deposits would not be held in banks if there were a lack of confidence in their soundness. Moreover, consumer confidence has been mounting over the years, with favorable views by the public increasing from 25 percent of the population in 1994 to 75 percent in 2000.

Membership in the OECD, financial sector reforms adopted in 1997, the absence of major bank failures (even during the emerging market crisis), and the significant increase in prime-rated foreign investment has helped build that confidence as Poland moves towards membership in the European Union. Concentration has continued to diminish over the years, and the best performing banks are ones listed on the WSE, which are subject to high levels of regulatory and market scrutiny. Thus, market discipline has taken hold, and incentives are increasingly in line with global standards.

There has been increasing investment from the private sector in banking, particularly since 1996. Strategic investment has been prominent since 1998. All of this has been reinforced by the sustained development of effective banking supervision that has provided increasingly effective oversight since the mid-1990s.

Nonetheless, several weaknesses and challenges remain in the operating and regulatory environment for banking. First, there are questions about technical coordination across financial sub-sectors (i.e., banking, securities), and how the CBS would react in a period of banking crisis. While GINB has moved towards risk-based supervision, CBS is not evaluating risks to the banks on a fully consolidated basis. Second, there appear to be weaknesses in coordination at GINB between off-site surveillance and on-site inspection. Third, there appear to be serious weaknesses in neighboring countries' supervisory agencies, making Poland more vulnerable to cross-border risks. Fourth, it has been difficult to monitor affiliates of banks, and to ascertain actual control of resources. Cross-border activities add to the complexity of this challenge. Fifth, GINB is faced with serious personnel challenges in the coming years, as its funding faces potential constraints and employees move on to more attractive compensation schemes in the private sector. Beyond GINB and supervision, while PKO BP and BGZ may no longer be serious supervisory concerns, they are potential vehicles of political patronage, and they continue to draw on assistance funds of the BGF at the expense of the banking system. The Bank Guarantee Fund has been used to assist these banks over the years, distorting the playing field. Meanwhile, the legal framework has gotten better for banks, but judicial obstacles remain as the court process remains slow and costly.

4.7 Transparency and Disclosure: Score: 3

Poland adopted legislation in 1997 that defines the guidelines under which banks need to provide information to regulatory authorities. Poland's largest banks have been subject to increasing levels of scrutiny based on high levels of disclosure. Disclosure became increasingly public for banks as they were put on the privatization track. In particular, for banks listed on WSE—about 28 percent of WSE's capitalization derives from 16 banks—information disclosure has had to meet international standards to conform to market requirements, and later to succeed in attracting strategic investment.

There have been shortcomings over the years with BGZ and PKO BP, although this might soon change with PKO BP's planned privatization next year. In terms of companies and households, there is less transparency and disclosure, which undermines the effectiveness of banks to share information with each other for improved credit risk assessments. The new credit information bureau developed in conjunction with the Polish Banking Association may change this to some degree as banks push more deeply into retail markets, as debit and credit cards and point-of-sales terminals are increasingly utilized, as consumer lending increases, and as factoring, leasing, and commercial credit companies start to emerge. However, the need for market-based systems is still abundant.

Concerns about confidentiality abound, partly the result of pre-transition constraints on freedom and partly to evade the fiscal authorities. While these reactions are understandable, such absence of transparency makes it more difficult for Poland to develop effective credit information systems for better banking (and for credit rating agencies in support of capital markets development). As banks and others expand into retail services and securitized markets, disclosure and transparency will also need to increase to further develop these markets. This will eventually need to apply to the housing market as well.

These kinds of institutional developments can be expected to lead to "market-regulated" information requirements. By then, it is also anticipated that companies and households will be willing to endure some loss of confidentiality in exchange for greater access to financial resources. This may already be happening now, as listings on the free and parallel market increase, and as consumers are benefiting from banks' increased lending and services in this area since 1996.

4.8 Sensitivity to Market Risks: Score: 3

Poland does not currently appear to be overly sensitive to "contagion" risks. Poland's banks and markets have withstood the crisis in Asia, weakness in Russia, and the withdrawal of investment from emerging markets. To date, Poland has come through this period with its banks and markets generally in place, with significant foreign direct investment, continued portfolio investment, and continued high levels of real GDP. Its performance is laudable, notwithstanding continued challenges that exist with regard to the inflation rate, fiscal balances, the current account deficit, rising unemployment, and difficulties in the agricultural and industrial sectors.

Now that Poland has liberalized the capital account and moved to a free floating exchange rate, higher levels of volatility in exchange rates and asset values seem inevitable. Maintaining high levels of foreign exchange reserves will continue to serve as a buffer from a macroeconomic standpoint, and this is projected to continue for the next two or three years as Poland still has many companies to privatize. At the firm-specific level, increased use of hedges against various market risks will be needed to protect against dangerous losses. From a broader perspective, there are continued risks regarding fiscal balances with elections coming up, and any reversal of what looks like a stronger period of growth in the Euro zone would weaken Poland's export prospects.

There are also macroeconomic risks regarding inflation and interest rates. The market has already begun to discount the likelihood of MPC achieving its inflation targets for the second consecutive year, and discussion by MPC of an increasingly wider tolerance band to be established in the coming years to better mitigate the impact of potential shocks may weaken discipline in this regard. The proposed increase in the tolerance band from 0.5 to 1.4 within one year raises questions about how this will be perceived in the business community, particularly if inflation targets are again not met. On the other hand, international announcements regarding oil prices may eventually ease pressure on commodity prices, one of the contributing factors to higher inflation rates in Poland since 3Q 1999.

One of the most persistent problems Poland faces is its current account deficit, which has steadily widened since 1996-97 and appears less affected by higher interest rates. Preliminary figures in the early months of 2000 show sustained deficits notwithstanding a 450 basis point increase in interest rates since November. While there is evidence from 2Q 2000 that banks are slowing down some of their consumer lending, current account deficits continue to mount.

At the banking level, there are many risks that could lead to stress in this sector. These include (i) fundamental credit risk—consumer lending and third party exposures (e.g., syndications, acceptance of company paper, overvalued collateral, tax fraud), (ii) exchange rate risk—particularly with a free float, and reports of unhedged positions, (iii) possible mismatches in the term structure of portfolios—use of term deposits to finance short-term loans, (iv) possible mismatches in the currency composition of portfolios—use of foreign currency-denominated borrowings to finance short-term loans in zloty, (v) insufficient gap or duration analysis conducted by some banks to measure for sensitivities (e.g., interest rate, exchange rate, fixed-variable pricing) on weighted and time-to-maturity bases, and (vi) the need to conduct stress tests combining interest rate, exchange rate, concentration and maturity assumptions to better manage risks as portfolios grow in complexity. These fundamental risks were in play in 1997-98, and Poland's results have been fairly sound. However, the banking sector did endure weak earnings in 1998-99, and the potential for bigger losses resulting from foreign exchange and asset valuation shifts is there now.

It is unclear to what extent banks engage in stress testing of portfolios, contingency planning for shocks, or other kinds of risk management practices. The large foreign banks are acknowledged to have strong systems. However, GINB concerns about internal controls and audit at many of the smaller Polish banks suggests these banks are vulnerable unless they manage their resources carefully. The collapse of Bank Staropolski was costly to the private banking sector, even though Staropolski was not a large bank. Thus, banks themselves will need to play more of a policing role to shore up the market as a whole. On this front, better communication between market players and GINB may be needed to avert a recurrence.

Future risks will emerge with increasing competition at the retail banking level—mainly from the increasing use of credit cards—as well as rising interest in loan syndications, securitization with a range of features, and mortgage lending. As elsewhere around the globe, internet banking will present opportunities as well as risks. However, for now, capital appears adequate,

	asset quality appears stable, management and governance have improved, and the general operating environment is increasingly competitive. New management systems have been put in place to advance the market, and to protect against risks. Weaknesses are in earnings and the still limited funding base of the banking system. Macroeconomic prospects are still based on high real growth, with favorable prospects for increased trade in the Euro-based markets. However, inflation, structural and fiscal weaknesses persist, as do high current account deficits, and these all increase the likelihood that interest rates (and associated risks regarding loan default and rising portfolio problems) will remain high for the coming months.

ANNEX 1: A DESCRIPTION OF THE USAID BANK RATING SYSTEM

Ratings Summary for USAID					
Topics/Categories and Description of Coverage	**Description of Ratings**				
	1 = DISMAL	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
General Description of Ratings: • Financial infrastructure • Economic factors and indicators • Banking sector structure and profile • CAMELOTS indicators	Monopolistic; state-owned banks dominate; no public confidence; lack of intermediation and widespread directed lending; lack of banking legal and regulatory structure; nascent regulatory institutions; widespread corruption	Little competition; weak household deposit growth; limited intermediation; diminishing directed lending; poor legal and regulatory structure and implementation	Growing competition; private banks dominate; steady household deposit growth; growing intermediation; adequate legal and regulatory structure, but inconsistent implementation; regulatory institutions are sustainable	Healthy competition; expanding intermediation to all enterprise sectors and households; growing lists of products/services offered; good legal and regulatory structure, and consistent implementation; credible regulatory institutions	Competitive globally; thriving financial intermediation; full range of products/services offered; diversified and sustainable earnings; strong legal and regulatory structure

I. FINANCIAL INFRASTRUCTURE					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
1.1. Policy/System	Wholly unsupportive of stable, safe and sound banking	Generally unsupportive of stable, safe and sound banking; significant improvements needed	Partly supportive of stable, safe and sound banking, but improvements needed	Supportive of stable, safe and sound banking	Wholly supportive of stable, safe and sound banking
1.2 Legal	Wholly unsupportive of stable, safe and sound banking and meaningful levels of risk-taking	Generally unsupportive of stable, safe and sound banking; virtually no meaningful levels of risk-taking	Fairly supportive of stable, safe and sound banking, but implementation deters meaningful levels of risk-taking	Supportive of stable, safe and sound banking and meaningful levels of risk-taking	Wholly supportive of stable, safe and sound banking and meaningful levels of risk-taking
1.3 Regulatory and Supervision	Wholly inadequate for prudently managed and supervised banking	Inadequate regulatory framework for prudently managed and supervised banking; significant strengthening needed	Adequate regulatory framework for prudently managed and supervised banking, but strengthening needed	Solid regulatory framework for prudently managed and supervised banking	Outstanding regulatory framework for prudently managed and supervised banking
1.4 Payments System	Wholly inadequate and undermines integrity of banking system	Inadequate and inefficient systems weaken limited efforts to build up integrity	Adequate but less than efficient systems support increasing integrity of	Solid systems reinforce integrity of banking system	World class systems reinforce integrity of banking system

		of banking system	banking system		
1.5 Accounting	Wholly inadequate framework for banking	Unacceptable framework for banking; significant improvement needed	Acceptable framework for banking, but sophistication needed	Satisfactory framework for banking	Outstanding framework for banking
1.6 Rating Agencies and Systems	Wholly unsupportive of banking sector development	Generally unsupportive of banking sector development	Marginally supportive of banking sector development	Supportive of banking sector development	Wholly supportive of banking sector development
1.7 Financial Media	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth; professionalization and code of ethics needed	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1.8 Professional Associations	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1.9 Academic	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1.10 Miscellaneous	Wholly inadequate and undermines integrity of banking system	Generally unsupportive of banking system; significant improvement needed	Only partly supportive of banking system, but improving	Supportive and reinforces integrity of banking system	Wholly supportive and reinforces integrity of banking system

II. ECONOMIC FACTORS/INDICATORS					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
2.1 General	Dismal macroeconomic fundamentals undermine banking sector development	Inadequate macroeconomic fundamentals deter risk-taking by banks	Adequate macroeconomic fundamentals assist with banking sector stability	Solid macroeconomic fundamentals provide banking opportunities	Outstanding macroeconomic fundamentals reinforce and enhance banking sector
2.2 Private Sector Development	Poor levels of private sector development in formal economy undermine banking development	Growing but inadequate levels of private sector development for sustainable, meaningful growth undercut banking sector development	Adequate private sector development supported by favorable trends, but improvements needed	Strong economy based on competitive private sector	World class, state-of-the-art economy predicated on innovative, resourceful private sector
2.3 Money, Savings and Credit	Dismal monetary fundamentals wholly undermine banking sector development	Weak monetary fundamentals deter banking sector development	Adequate monetary fundamentals boost confidence, but improvement needed	Solid monetary fundamentals contribute to strong banking system	Solid monetary fundamentals, shaped by world-renowned risk management practices, contribute to global standards of banking system competitiveness
2.4 Fiscal	Dismal fiscal fundamentals wholly undermine banking sector development	Weak fiscal fundamentals deter banking sector development	Adequate fiscal fundamentals boost confidence, but improvement needed	Solid fiscal fundamentals contribute to strong banking system	Solid fiscal fundamentals contribute to stability in support of banking system competitiveness
2.5 Exchange Rates	Dismal exchange rate fundamentals wholly undermine banking sector development	Weak exchange rate fundamentals deter banking sector development	Adequate exchange rate fundamentals boost confidence, but improvement needed	Solid exchange rate fundamentals contribute to strong banking system	Solid and stable exchange rate fundamentals, shaped by world-renowned risk management practices, contribute to global standards of banking system competitiveness
2.6 Balance of Payments	Dismal balance of payments position reflects competitive weaknesses of economy	Poor balance of payments position reflects competitive weaknesses of economy	Adequate balance of payments position reflects growing competitiveness of economy despite weaknesses	Reasonably strong balance of payments position reflects competitive strengths of economy	Enviably strong balance of payments position reflects competitive strengths of economy

III. BANKING STRUCTURE AND SYSTEM PROFILE					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
3.1 Overview	Wholly uncompetitive banking system	Poor reputation re competitiveness in the banking system	Adequate reputation for competitiveness in banking, but strengthening is needed	Solid reputation for competitiveness in banking	World class status re competitiveness in banking
3.2 Ownership	Monopolist, protectionist banking system resistant to foreign competition and change	Traditionally closed banking system only beginning to open up to foreign competition and change	Adequate levels of competitiveness and performance due to recent trend towards private ownership and management	Reasonably open and generally privately owned and managed banking system respected for competitive position	Open, privately owned and managed banking system globally respected for competitive prowess
3.3 Governance and Management	Dismal governance and management undermine banking and economic development	Weak governance and management undermine banking development despite recent but very marginal improvements	Adequate governance and management for banking, but improvements needed to achieve global competitiveness in banking	Strong governance and management sustain competitiveness in banking	World class governance and management reinforce and sustain competitiveness in banking
3.4 Non-Bank Competition	No serious competition from non-banks further undermines the need for financial discipline	Very limited competition from non-banks provide little pressure on banks to exercise financial discipline	Adequate levels of competition from non-banks, but lack of market breadth and depth limit impact on competitiveness and financial discipline of banks	Satisfactory levels of competition from non-banks enhance competitiveness and financial discipline of banks	Significant competition from non-banks further strengthens levels of competitiveness and financial discipline of banks

IV. BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =O UTSTANDING**
4.1 Capital Adequacy	Wholly inadequate capital	Inadequate capital	Adequate capital	Reasonably strong capital	Enviably strong capital
4.2 Asset Quality	Dismal asset quality	Poor asset quality	Adequate asset quality, although significant room for improvement	Reasonably strong asset quality	Enviably strong asset quality
4.3 Management	Wholesale disregard for fundamentals of risk management	General lack of awareness of risk management fundamentals	Fairly weak but improving reputation based on emerging risk management capacity in a market showing increasing levels of competition	Reasonably strong reputation based on satisfactory risk management capacity in a fairly competitive market	Enviably strong reputation based on world class risk management capacity in fiercely competitive market
4.4 Earnings	Sustained losses that have decapitalized the banks by IAS	Weak or unstable earnings	Adequate earnings, but room for added stability and diversification	Reasonably strong and diversified earnings	Enviably strong and diversified earnings
4.5 Liquidity	Severe liquidity problems	Liquidity problems	Adequate liquidity position, but room for strengthening	Reasonably strong liquidity position on an ongoing basis	Enviably strong liquidity position on an ongoing basis
4.6 Operating and Regulatory Environment	Dismal operating and regulatory environment	Poor operating and regulatory environment	Adequate and improving operating and regulatory environment	Reasonably strong operating and regulatory environment	Enviably strong operating and regulatory environment
4.7 Transparency and Disclosure	Dismal standards for transparency and disclosure	Weak standards for transparency and disclosure	Adequate standards for transparency and disclosure	Reasonably strong standards for transparency and disclosure	World class standards for transparency and disclosure
4.8 Sensitivity to Market Risk	Dismal reputation for sensitivity to market risk under market conditions	Poor reputation for sensitivity to market risk under market conditions	Adequate and improving reputation to manage sensitivity to market risk as market conditions increasingly prevail	Strong reputation to manage sensitivity to market risk under market conditions	World class reputation to manage sensitivity to market risk and continuously prosper under market conditions

ANNEX 2: A DETAILED ASSESSMENT OF THE POLISH BANKING SECTOR

I. FINANCIAL SECTOR INFRASTRUCTURE

Poland has made significant strides towards financial sector modernization in the last few years, with prime-rated foreign investment and increasing electronic capacity constituting the biggest changes since 1997-98. Strategic investment has materialized from the privatization of Pekao SA, BPH and Zachodni, as well as from an increase in investment from institutions that had earlier invested in banking franchises in Poland[2]. More recently, Citigroup's acquisition of Bank Handlowy signaled that institution's continued commitment to the Polish and regional market. While two major banks still remain state/Treasury-owned, Poland has generally moved down an irrevocable path of private ownership in the banking system over the last few years, with particular focus on strategic investment since 1997[3].

Investment in electronic capacity permeates the system, and has been partly driven by the public sector—NBP has required that banks transmit regular reports electronically for years, and more recently, GoP has mandated that all pension payments be done through the electronic payment system. The Y2K effort also required investment in new systems. As elsewhere, banks in Poland are recognizing the need for heavy investment in new systems for operational efficiency and regulatory compliance, as well as to provide a broader range of services to the market.

While financial intermediation statistics are still lower than in EU countries, general trends are favorable. Lending and deposit mobilization have increased, the range of maturities has expanded, rates have come down, and more people and businesses now have accounts. Polish banks are providing a wider range of services than just a few years ago, and this will continue as the banks become more competitive and as universal banking takes hold. Already, public opinion of banking has improved over the last two years, partly because competition is driving banks to be more service-oriented at the retail level.

Poland's strengths continue to be a growing economy geared to EU and global markets, increasing liberalization and investment in the banking sector, high standards of accountability, increasing professionalization, and supervisory structures for banking, insurance and capital markets that are based on guidance from the Basle Committee on Banking Supervision and the Joint Forum on Financial Stability. Legal reforms in banking introduced in 1997—The Banking Act and The Act on the National Bank of Poland[4]—reinforced these structures and provided a broad mandate for enforcement. Amendments are being introduced in 2000 to account for the needs of consolidated supervision, to toughen penalties and sanctions, and to prevent a repeat of recent scandals in the banking and insurance sectors[5].

There is a need for better technical coordination among regulatory authorities to identify

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2 The Bank Zachodni privatization is an example. Allied Irish Bank (AIB) originally started with a minority stake in WBK in Posnan. This subsequently increased to a majority stake. AIB then bought Zachodni (based in Wroclaw) to consolidate its position in western Poland.

3 It remains to be seen if Poland will pursue the same approach with the privatization of the remaining non-private banks. In the cases of PKO BP and BGZ, the general view is that the government would float shares on the local exchange rather than seeking strategic investment, at least during the first phase of privatization. The privatization of PKO BP is projected for 2001. It is not currently known when GoP would initiate the privatization of BGZ, although it is likely to occur in 2002 or 2003.

4 Both of August 29, 1997.

5 Bank Staropolski and Polisa Insurance both engaged in practices that led to losses and their closures.

and monitor for financial sector risks, and sufficient capacity to ensure that life insurance and pensions are properly managed so that policy holders benefit from adequate consumer protection standards. The framework is already in place and evolving, as EU guidelines are being used to map out developments in the pension and insurance sectors. Proper oversight of financial condition, investment policy, consumer protection and potential links to systemic risk in the banking sector may become more of a challenge in the insurance sector as this market matures in the coming years.

Governance at the state commercial banks and major private banks has improved since late 1993. The 1997 Banking Act spells out basic governance requirements for all banks, including state and cooperative banks[6]. Privatization moved forward over the last two to three years, and there are now only two major banks and five smaller banks that remain in non-private hands. Membership in the OECD and future entry into the EU are all providing momentum for institutional reform.

Poland's payments system has improved in the last two years, with all branches now linked electronically and evidence of a gradual decrease in paper-based transactions as a percentage of total.

Accounting standards have been moving increasingly towards international norms, sustained largely by requirements for the largest reporting banks, the due diligence process that comes with privatization and larger joint-ventures involving equity stakes, and demands from the market on companies trading in the capital markets. However, there is still reported to be a big gap between the Big 5 firms and local Polish accounting firms in terms of accounting and audit standards.

Poland continues to benefit from support organizations that enhance and help sustain market development—rating agencies, professional associations, media, academic and training institutes. Advances in the telecommunications sector have also helped with overall modernization efforts. **Score: 3+**

1.1 Policy/System

Poland was earlier perceived to be partly protectionist with regard to several "strategic" sectors (e.g., coal, steel, agriculture), and slow with privatization. While there are still about 3,000 non-private firms, Poland has moved towards full implementation of a market economy over the last few years. This is particularly evident in the services, where private companies dominate.

In the financial sector, there has been clear movement towards a private banking system. The insurance sector has not moved as quickly, although the plodding privatization of PZU and significant investment from foreign insurers in recent years will ultimately transform insurance into a private sector-driven one. The capital markets are relatively small, but they are well regarded and did not suffer the same level of turbulence and outflows as experienced in many other emerging markets in recent years.

More generally, Poland has shown considerable economic growth in real terms since 1994. If there were earlier doubts about the environment for foreign investors, these concerns appear to have abated in recent years as foreign direct investment has increased considerably. General weaknesses exist with regard to labor productivity in the troubled coal and steel sectors, and the lack of competitiveness of many SMEs. However, Poland is perceived to be on the right track,

[6] New legislation was originally interpreted to meet minimum EU guidelines, with changes expected as the system evolved. Amendments are expected later in 2000 to address consolidated supervision issues.

largely the result of its membership in OECD and movement towards entry into the EU.

While there are reports that negotiations with the EU have slowed and that entry will not occur for several years, this is also partly because Poland has taken issue with the EU on the Common Agricultural Policy, and other issues within the EU that have an effect on restructuring within Poland (e.g., overcapacity in the steel sector). Poland has introduced major reforms in recent years that will ultimately create capacity to assume the obligations of EU membership. This includes privatization in the banking sector, increasing private investment in the insurance and telecommunications sectors, and major reform of the social insurance system. Poland has also shown its commitment to democracy, free trade, and multilateral cooperation. Poland's legal and regulatory structure has been partly reformed to conform to these prerogatives, even if judicial systems and capacity still require improvements.

At the structural level, Poland's banking and financial system have undergone considerable reform since 1989. Its regulatory structures are considered reasonably strong, and this should provide for added institutional security in banking, insurance and capital markets in the coming years as trade and investment in financial services increase. In the real sector, there is recognition of the need for additional investment and increased productivity, particularly in the primary and secondary sectors. Agriculture remains a particularly difficult challenge due to traditional ownership patterns, demographics, and political resistance to change. Recent challenges in the merchandise trade accounts have pointed to the need for industrial modernization, some of which is beginning to occur in the form of capital investment and reduced head count. Services represent a steadily increasing share of GDP and employment, which is consistent with patterns elsewhere in Europe. **Score: 3+**

- The *political environment* has been typically contentious and, yet, comparatively stable in Poland for years. Several continuous years of government turnover in parliament and disagreements between the executive and legislative branches slowed the reform process in earlier years. However, since the mid-1990s, broad public support for entry into NATO and the EU have provided a framework in which to pursue reforms, notwithstanding some of the costs involved. Poland's government has reflected diversity and balance in recent years, with the President representing the Democrat Left Alliance and the parliament dominated by a center-right coalition of the Freedom Union and the Solidarity bloc. Even with the recent departure of the Freedom Union from the coalition in June 2000, there is agreement between the two parties on certain positions and issues. As an indicator of maturity and relative stability, the market had already factored in the political risk of a change in the coalition to its calculations[7], as shown in the limited change in securities prices and exchange rates in subsequent days after the announcement. Poland's institutions guarantee the rule of law, human rights and the protection of individual and minority rights. According to the EU, there are still weaknesses with regard to agriculture, environmental protection, and the privatization of land. However, in the financial sector, there are only minor issues of concern, and these are likely to be resolved in the coming years[8].

- Poland's *governmental system* is organized as a parliamentary democracy according to the permanent constitution adopted in 1998. Poland has a bicameral parliament comprised of a lower house (*Sejm*) and an upper house (Senate). Poland introduced administrative reform at

[7] See "Investors learn to disregard Pole who cried wolf," *Financial Times*, May 26, 2000.

[8] The current issues are the role of BGK as a special purpose financing vehicle for GoP, minimum capital requirements for cooperative banks, and the calculation of own funds.

the beginning of 1999. Prior to this date, Poland was divided into 49 provinces (*voivodships*), each of which was headed by a provincial governor (*voivode*) appointed by the central government. There were also independent, locally elected city and village governments. With reform, there are now 16 voivodships, with locally elected assemblies. However, these governments have very limited financing, and still rely heavily on central government transfers. Over time, local governments will need to increase their revenue-generating capacity to assume responsibility for the local economy, water supply, sewage systems, roads, and public transport. There is a risk of increasing corruption and patronage as a result of such a devolution of responsibility.
• Poland is a *member of major international organizations* such as the World Trade Organization (WTO), European Free Trade Agreement (EFTA), Central European Free Trade Agreement (CEFTA), the World Bank (IBRD), the International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development (OECD). Poland was among the first three countries of the former socialist bloc invited to join NATO in 1997, with formal entry occurring on March 12, 1999. Currently, Poland is one of six countries slated for "first tier" entry to EU membership[9], anticipated some time in 2002-05[10]. However, pressure from the EU on Poland to introduce major changes to agriculture and land markets, and to tighten border controls have led to lower levels of public support for joining the EU. According to some recent surveys, public support has dropped from 70 percent just two years ago to the 46-55 percent range[11]. Nonetheless, there is clear expectation of formal entry some time in the coming years. To date, Poland has closed 10 chapters in its negotiations with the EU. The most difficult areas in future negotiations are expected to be in agriculture. With regard to financial services, Poland is active in implementing guidelines recommended from the Basle Committee on Banking Supervision and the Joint Forum on Financial Stability.
• With regard to *legal and regulatory reform*, there is a perception that judicial institutions need strengthening to be effective. In particular, there is a need for judges and commercial lawyers specialized in banking and finance, and a better understanding of international standards, norms and codes of conduct in banking and business. Poland recognized this issue earlier in the 1990s, and combined with pressure for reform from the business community, the EU, IFIs and other institutions, Poland has made several changes in the last two years. Specific to the banking sector, Poland introduced legal reforms on August 29, 1997 with passage of The Act on the National Bank of Poland and The Banking Act. These laws provide a framework that is more conducive to risk-taking for banking based on enforceable contractual agreements with the enterprise and household sectors. Previous problems included reliance on a Commercial Code dating back to 1934, and the after-effects of decades of non-commercial applications that protected debtors at the expense of creditors. As for banking, reasonable protection was provided under the 1993 Act on the Financial Restructuring of Enterprises and Banks.

[9] Others negotiating with the EU from the first group are Cyprus, the Czech Republic, Estonia, Hungary and Slovenia. A second group of transition countries is also negotiating entry—Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic—although these negotiations just recently began. To date, Cyprus is the most advanced in its negotiations with the EU, having closed 15 of 31 chapters.

[10] An EU Association Agreement was signed in March 1992, along with Hungary and the Czech-Slovak Federal Republic. These were the first Association Agreements signed.

[11] See CBOS, October 1999 and Demoskop, February 2000, as cited in "Economic and Financial Outlook," Citibank (Poland) S.A., June 2000. Also see "The Annual: 2000," *Business Central Europe*.

However, significant problems persisted beyond that Law's enactment and the restructuring activities that ensued. These included a slow court process, disorganized and incomplete property registries, and the existence of multiple claims on properties due to the inability to perfect liens. This led to a cautious, risk-averse approach to lending by banks—there was little lending until late 1995—and most of the lending that was provided was short-term and heavily secured[12]. The Banking Act adopted in 1997 provided greater legal backing to banks in the area of debt collection, including the use of debt collection agencies and liquidators for asset repossession and disposition when debtors were unable to comply with legal agreements. While not the sole reason for an increase in lending to the business sector, enabling legislation in 1997 helped to create more conducive conditions for risk-taking within the prudential regulatory framework. Key additional Acts passed by Parliament along with or since these two fundamental Acts have addressed securities trading, mortgage bonds and mortgage banks, and foreign exchange. Implementing legislation has included ordinances, regulations and resolutions related to official guarantees, Treasury debt sales/swaps/repayments/cancellations, business mergers, brokerage/securities activities (including lending to brokerages), monetary policy requirements, bank accounting principles and financial statement consolidation, internal controls and audit, bank capital and capital adequacy ratios, credit risk (derivatives, capital investment, large exposures, real estate appraisals), foreign exchange risk, interest rate risk, operational and IT/telecommunications risk, and deposit insurance[13]. Additional amendments are expected in banking and other financial services in 2000. In banking, amendments may address existing weaknesses pertaining to the cross-ownership structures of banks and non-banks so that NBP/GINB can carry out more effective supervision. Other legislation being amended relates to bonds, securities markets, and accounting/audit standards. In addition, it is likely that a central financial inspection unit will be established to focus on money laundering, fraud and other related criminal activity.

- *Economic* developments in 1999 were less favorable than originally projected in Poland, and below growth rates achieved in 1998. Real GDP growth was 4.1 percent, less than the 4.8 percent achieved in 1998 and the 6.25 percent average from 1994-97. The main causes of this decline included growth of the current account deficit, a rise in the year-on-year inflation rate, greater than expected public expenditure due to higher costs associated with structural governmental reforms, rising unemployment, and reduced savings. The current account deficit rose to 7.6 percent of GDP in 1999, up from 4.5 percent in 1998, due to reduced demand in EU and Russian export markets, the decline of which exceeded the decline of imports[14], and an increase in debt service payments which added to the net deficit in the services accounts. The average inflation rate (i.e., CPI) declined from 11.8 percent in 1998 to 7.3 percent in 1999. Nevertheless, December-on-December CPI increased to 9.8 percent for 1999 against 8.6 percent at year end in 1998[15]. Moreover, these rates continued to increase through the first

[12] It should be noted that this was perfectly prudent and reasonable behavior by the banks. Net spreads on GoP securities were high, and holding these securities made it easier for banks to comply with capital requirements. Moreover, risk-taking required better information and more work on the part of the banks. Thus, until these spreads declined, banks had little incentive to lend.

[13] For selected legislation relating to the banking system, see Appendix 4 of "Summary Evaluation of the Financial Situation of Polish Banks: 1999," National Bank of Poland, April 2000.

[14] According to NBP, export receipts declined by 3.1 percent to $27.4 billion, while import payments declined by 2.5 percent to $45.9 billion. See "Summary Evaluation of the Financial Situation of Polish Banks: 1999", p.11.

[15] The comparable PPI measure showed an 8.0 percent increase in 1999 against 4.8 percent in 1998. Thus, higher inflation was felt at the wholesale/producer level as well as at retail/end-use levels.

half of 2000. Rising prices have resulted from increases in fuel prices (liquid, electricity, gas), rents, transport and other services, and food. The fiscal deficit was 3.8 percent of GDP[16]. This was largely due to higher than expected costs associated with local government reform, health care, education and social insurance[17]. Concerns about rising prices prompted the Monetary Policy Council to raise interest rates[18]. The unemployment rate increased to 13 percent at end 1999, up from 10.4 percent at end 1998. While this was less than 16.4 percent at end 1993 and 13.6 percent at end 1996, the trend was clearly unfavorable. NBP reported that unemployment climbed to 13.9 percent by March 2000, with four of 16 voivods showing unemployment rates of 17.5-22.8 percent. The unemployment rate was increasing due to slower economic growth, and more capital/technology-intensive, labor-shedding efficiencies introduced in the industrial sector. With a decline in exports[19], NBP reported consumer demand as the main engine of growth in the Polish economy. However, personal incomes increased only marginally. Thus, increased consumption was fueled by a reduced rate of savings and increased personal/household borrowings to finance purchases. Meanwhile, the exchange rate continued to depreciate against the U.S. dollar, from PLN 3.49 at year-end 1998 to PLN 4.17 at end 1999. Debt ratios remain satisfactory, but they have increased in recent years. However, the significant increase in the current account deficit, from US$4.5 billion in 1997 to US$11.7 billion in 1999 was and remains a major cause for concern. Moreover, Poland's stock of debt has increased in recent years, and this is expected to impact the current account and reserves in 2002-2006.
• The *banking* sector continued to develop and modernize in preparation for entry into the European Union. Bank assets were 59.6 percent[20] of GDP at end 1999, up from 52.8 percent at end 1997. While still low by OECD and EU standards[21], these figures have increased in Poland in the last two years from what were otherwise relatively unchanged figures from 1991. This trend is actually favorable due to the improved asset quality of the measure, although the slowdown in GDP growth since 1998 also influences the trend. In addition to general asset growth, all of Poland's 77 commercial banks are above the EU minimum for capital[22]. Only four banks have assets of less than PLN 100 million (less than Euro 25 million), and 36 banks have at least PLN 1 billion (more than Euro 250 million). This represents a trend towards gradual consolidation and larger balance sheets. However, most of Poland's banks

16 The central fiscal deficit remained within Maastricht EMU criteria, at 2.4 percent, although local government and off-budget items would raise this to nearly 4 percent.

17 High social security and pension costs were the most conspicuous expenditure item, although this is not expected to recur. Some of the costs associated with social insurance in 1999 were extraordinary and reflected changes to the system and data management problems.

18 Interest rates increased significantly in late 1999, as the Monetary Policy Council increased rediscount and Lombard rates by 350 basis points. This brought interest rates up slightly above rates found at end 1998 (on a nominal basis), and significantly higher in the 3-month WIBOR rates. The MPC raised rates again by another 100 basis points in 1Q2000.

19 There are differing interpretations of how much exports are really declining. NBP figures show declines, but customs data show the trend is far less severe. Also, international transactions are reported in US dollars, whereas approximately 60 percent of payments and 70 percent of trade is Euro-based. In 2000, export figures have been affected by the relative depreciation of the Euro to the US dollar in these calculations.

20 This figure includes the cooperative banks.

21 For instance, bank assets/GDP were 154.2 percent among the EU-15 in 1996, vs. 44.1 percent in Poland. See Orlowski, L., "The Development of Financial Markets in Poland", 1999.

22 Minimum capital for a basic bank license in the EU is Euro 5 million.

remain small by global standards. The average majority Polish-owned bank averaged PLN 4.7 billion (about Euro 1.2 billion) in assets and PLN 81 million (Euro 20 million) in equity at end 1999. Netting out BGZ and PKO BP[23], the average balance sheet measures become much smaller, approximating PLN 2.4 billion (about Euro 600 million). Some have specialized market niches, but most will need to grow through mergers or new share issues if they are to be competitive in the market. At the larger end, Bank Handlowy raised more than $1 billion in new capital with its share issue in June, 1997. It has recently been acquired by Citigroup for about $750 million[24]. A second large acquisition nearly occurred in 2000, with Deutsche Bank seeking to acquire BIG Bank (and its subsidiaries). However, this was resisted by BIG Bank's management board and ultimately abandoned by Deutsche Bank to avoid bad publicity and time-consuming disputes. Nonetheless, Deutsche Bank remains active in the Polish market through its subsidiary, and may seek to acquire another bank to boost its presence. The biggest transaction in 1999 was the privatization by UniCredito of Italy[25] of Pekao SA Group in 1999, which acquired 52 percent of bank shares for PLN 1.5 billion. PBK-Warsaw and BRE had earlier been privatized with strategic investment from Bank Austria Creditanstalt and Commerzbank, respectively. BPH also received strategic investment from HypoVereinsbank in 1999, with the latter taking an 81.5 percent stake. In some cases, strategic investors have increased their positions, as in the cases of PBK[26], WBK[27] and BRE[28]. However, PKO BP, BGZ, some smaller private banks, and some of the cooperative banks appear either to still be troubled, or not yet ready to be privatized. NBP has tried to contain the structural defects of the larger problem banks (e.g., the maturity structure of mortgage loans, traditional lending role to the primary sector) from spreading risk through the banking system. However, PKO BP and BGZ still represent about 22.5 percent of banking system assets, more than 30 percent of deposits, and about 12 percent of total capital. They both continue to benefit from forbearance in the form of lower reserve requirements and funding from the Bank Guaranty Fund. Despite clean-up and modernization efforts, their continued existence represents the ongoing risk of being utilized for patronage or other non-commercial purposes. In terms of financial measures, the marketplace has becoming increasingly competitive in recent years. The blue chip market was saturated by 1998, and the increased entry of foreign banks intensified that competition. This trend has been evident in neighboring countries as well, particularly in Hungary. Perhaps the most significant dynamic in the Polish banking sector is the increasing presence of strategic foreign investors in major Polish banks. These banks have been competing for corporate market segments while introducing new electronic services at the retail level. Lending continues to increase, with consumer credit for auto financing and other purchases representing a major source of growth for many bank portfolios. Banks also continued to modernize their infrastructure and to offer electronic services and plastic cards. This modernization has benefited from the legal mandate for the use of banks for pension payments under the new pension system. Earnings leveled off in 1997, and declined in 1998-99. Lower inflation rates have translated into lower nominal income and cost figures (although this has

[23] Combined, these two banks accounted for about 22.5 percent of banking system assets at end 1999, or nearly PLN 80 billion.

[24] Citigroup will own 75 percent of Bank Handlowy, and have 66 percent of voting rights. The total transaction values Bank Handlowy at about $1 billion.

[25] Allianz, the German insurer, is also a strategic investor in Pekao SA.

[26] Bank Austria Creditanstalt now owns 43.5 percent. Figures two years ago were about half that.

[27] Allied Irish now owns 60 percent of WBK, more than double its original stake.

[28] Commerzbank now owns nearly 49 percent of BRE, up from about 20 percent two years ago.

begun to change in 2000 with higher inflation rates returning). Cost ratios remain high, and ROA measures have been fairly low—ROA was only 0.67 percent in 1998 and 1.04 percent in 1999. Total net income for banks was PLN 3.3 billion in 1999, an increase from 1998 but still relatively low. (The Bank Staropolski loss weakened returns in 1999 by nearly PLN 0.5 billion, or about 13 percent of achieved net earnings. This would have raised ROA to about 1.2 percent in 1999.) The Polish banking system is evolving steadily towards a "universal" model in keeping with EU and global trends. Where there has been caution in recent years, it has been the objective of NBP to ensure that developments in the banking sector (and general financial system) are consistent with the implementation of monetary policy prerogatives, and within the capacity of regulators to properly supervise these developments in support of a safe, sound and stable banking system. This capacity was recently challenged, with the bankruptcy of Staropolski Bank in Posnan, although the system is broadly viewed as safe, sound and stable. A strengthening of institutional capacity will be needed for effective consolidated supervision. This will require more formal arrangements with supervisory authorities abroad, and better cross-sectoral coordination in Poland between banking, insurance, pension fund and securities regulators. This will also require a strengthening of supervisory capacity at each of these regulatory authorities, particularly in pension and insurance where overall capacity is viewed as less developed than in banking and securities.

- Poland has experienced growth in *capital markets and non-bank financial institutions*, although growth levels have been measured rather than dramatic. There are now about 63 active insurance companies, up from 55 in 1998. Insurance premiums approximated $4.7 billion in 1999, up from $3 billion in 1996-98 figures, and more than double the premiums in 1994 (when premiums were $1.8 billion). Legislation enacting pension reform in 1999 was expected to add resources for investment in the capital markets. There are currently more than eight million pensioners, and they will need to invest some of these proceeds. Recent indications show that about 30 percent of proceeds are being invested in WSE equities. Thus, in the coming years, a significant expansion of the capital markets is projected. This will be driven by a larger variety of financial instruments, some large-scale privatizations, and greater awareness on the part of the public of investment opportunities through brokerages, banks and other institutions. However, the WSE will continue to be small by global standards. A common view is that blue chips will migrate to major global exchanges (e.g., New York, London-Frankfurt), while regional exchanges will specialize (e.g., futures, options) or exist more for local market transactions (e.g., SMEs, local high tech). Notwithstanding the tendency towards global integration, there has been steadily increasing turnover and market capitalization on the Warsaw Stock Exchange (WSE) since 1991[29]. As of end 1999, market capitalization approximated PLN 123 billion ($30 billion at year-end exchange rates), or about 20 percent of GDP. This compares with 1998 market capitalization of PLN 72 billion (about $21 billion at year-end exchange rates), or about 14 percent of GDP. The number of firms traded on the WSE in mid-2000 numbered 226, as compared with 165 listed equities in mid-1998. Meanwhile, the over-the-counter (OTC) was poised for growth in 1998, but was unable to add a large number of companies because of competition from the WSE's parallel and free markets. While there were 25 firms listed on the CeTO in 1998, there were only 34 listed in 2000. It is possible that there could be some consolidation between the two markets, and there is the expectation that one of the larger European exchanges will eventually invite WSE to become a member[30].

[29] In 1991, there were only nine firms listed, and market capitalization approximated $144 million.
[30] See "WSE moves from abacus to hi-tech," Warsaw Business Journal, June 5-11, 2000.

By global standards, the capital markets and non-bank institutions are still relatively small. Poland experienced volatility in its markets in 1997 and 1998 with the East Asian and Russian crises. However, price movements have generally operated within a 30-60 percent range of annualized volatility. Among the 193 companies for which equities were listed in 1999, only 22 registered pricing volatility equal to or in excess of 60 percent. Among these were PBK, BIG Bank, and Polisa[31]. On that basis, WSE appears to have performed reasonably well in terms of handling concerns about the ruble, the spillover effects in the region, and the general withdrawal of institutional investors from emerging markets in 1998-99. Poland's capital markets (and overall economy) still remain vulnerable to portfolio movements, particularly now that Poland has moved to a free floating currency regime at a time when its current account deficit is high. About one third of funding comes from foreign investors—largely portfolio investment that could be removed fairly quickly. There is some concern of future risks of decapitalization—net profit transfers out of Poland by large financial institutions—although Poland's comparatively large population, and potential for significantly larger GDP once major privatizations take place, provide some measure of comfort compared to smaller regional economies that do not have as much of a "domestic" buffer. Poland's exchanges also enjoy an adequate reputation for accountability, integrity and transparency, although there are reports of some unevenness in the treatment of some listed companies. The failure of Polisa, a troubled insurance company, raised questions about the veracity of information supplied by the audit firm and the SEC's acceptance of such opinions.

- There was significant *socio-cultural or historical* enmity towards banking in the past, although it appears to have diminished in recent years. Recent public opinion surveys show that more than half of Poland's citizens have bank accounts, and about 75 percent have a favorable opinion of the banks[32]. In late 1994, only about 25 percent of people had a positive opinion of banks. Resentment was partly based on incidents of fraud that occurred in the early 1990s after licenses were issued to private banks. The difficulty many businesses and households had in accessing credit contributed to resentment, sometimes justifiably. Past attitudes were also considered to have contributed to the slow privatization of several financial institutions in banking and insurance. However, in recent years, more people have opened accounts and been able to access loans and other services. Effective supervision has contributed to efforts to reduce fraud and to ensure the safety of deposits. NBP has also introduced a public communications campaign to keep the business sector and households informed of key goals and objectives in the implementation of monetary policy, including activities in the banking sector. Meanwhile, the economy has grown, banks have introduced new products/services based on market demand, and lending at the consumer level has increased significantly. Consequently, about half of the population has accounts with banks, as compared with only about one in five in 1993[33]. As a further reflection of more favorable public opinion, several large banks have been acquired by foreign banks, particularly over the last two years. Thus, it appears that there is growing recognition among much of the public of the need for banking development and modernization as part of the larger ambition to become more closely engaged in regional and international organizations. Combined with better efforts at public relations, this may alter some of the negative perceptions that earlier prevailed, particularly as foreign banks

[31] See "WSE Fact Book", 1999.

[32] See surveys by Pentor and Banking Education and Research Foundation.

[33] The Polish Banking Association claims that more than 56 percent of the population has bank accounts. This compares with 20 percent of the population in 1993.

increasingly recognize the value of their Polish partners and customize their products/services to meet local demand.

1.2 Legal

Poland adopted the Banking Act and the Act on the National Bank of Poland in late 1997. This legislation brings much of the legal framework for banking in line with minimum EU standards, OECD member requirements, and BIS guidelines. The two Acts, representing improvements from earlier pieces of legislation, were also meant to provide a legal mandate to alleviate what had been problems associated with judicial infrastructure and the timely processing of claims, uncertainties regarding collateral and contract enforcement, and debt collection. Poland's legislation is generally considered satisfactory, although further changes are being discussed now to incorporate recommendations from BIS and the Joint Forum on Financial Stability, and to move Poland increasingly towards effective consolidated supervision to contain financial sector risks.

There are still weaknesses with regard to judicial infrastructure. Courts are overwhelmed with case loads they can not handle. Staffing and compensation levels are insufficient. More training in commercial practices is considered necessary.

With regard to banking, membership in the OECD has been accompanied by a major push for liberalization and consolidation, particularly since 1997-98. Poland's legislation recognizes home-country rule and mutual recognition principles in a manner consistent with EU Directives. However, Poland is taking the position that full opening will not occur until Poland becomes a member of the EU, which will not likely occur before 2002, and may not occur until 2005 or later. Banks' interest in securitization, consumer lending, "plastic cards," and mortgage lending has led to additional legislation. This legislation is considered to be broadly consistent with EU norms. **Score: 3**

- *The Law on the National Bank of Poland* (NBP), the first major piece of banking legislation after the fall of communism, became effective in 1989. This Law legally transformed Poland's banking system from a monobank system to a two-tier banking system[34]. The law also assigned responsibility for the implementation of monetary policy to NBP, namely through the use of monetary instruments to set interest rates. More recently, the Act on the National Bank of Poland was adopted on August 29, 1997. This Act details general provisions, the NBP's organizational structure (including the role of the President of the NBP, the Monetary Policy Council, and the NBP Management Board), the NBP role as a state institution, banking supervision, the issue of currency, monetary policy instruments, the operation of bank accounts, foreign exchange activity, the rights and duties of NBP personnel, NBP finances, and miscellaneous provisions. NBP also is empowered to act as a lender of last resort for commercial banks suffering from temporary liquidity constraints. The basic objective of NBP

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[34] With the break-up of the monobank system, Poland established the central bank as the first tier, while Poland's second tier consisted of four "specialized" banks—focused on agriculture (BGZ), retail foreign currency savings (PKO SA), long-term mortgage financing and local currency savings (PKO BP), and corporate foreign currency and trade (Bank Handlowy)—and nine "regional" commercial banks. Subsequent to 1989, three more specialized banks were established—the Polish Investment Bank, the Polish Development Bank, and the Polish Export Bank.

	remained focused on the maintenance of price stability. Changes to the original post-communist legislation related to the role of supervision and the new Commission for Banking Supervision, with the view to accommodating a more universal approach to financial services. The Commission is responsible for supervising the operations of the banks. The General Inspectorate of Banking Supervision, an autonomous entity within NBP, carries out these tasks on behalf of the Commission. The Commission for Banking Supervision is chaired by the NBP Governor, with six other members from the Ministry of Finance (two members), a representative of the President's office, the Bank Guarantee Fund, the Securities and Exchange Commission, and the General Inspector of Banking Supervision. Other key features to the legislation include monetary policy and implementation, including limits set on reserve requirements, and lender of last resort provisions, including NBP lending to the Bank Guarantee Fund. Amendments are expected later in 2000, mainly focusing on the need for a more conducive legal framework for consolidated supervision. In particular, NBP/GINB believes that it needs to be able to access more accurate, timely and comprehensive information on banks and their non-bank affiliates, and the ownership structures and control features of these entities. GINB also believes it should be freed of some of the legal and administrative challenges that are filed when depositors lose the uninsured portion of their deposits with banks[35]. The recent bankruptcy of Bank Staropolski generated criticism from the banks of GINB, namely delays in reacting to well known problems, failing to intervene in a corrective manner, and ultimately closing down a bank at a net cost of PLN 470 million to the banks[36], or 13.5 percent of net profits for the year. However, according to NBP/GINB, the criticism is unjustified because it believes administrative procedures and legislation do not provide NBP with sufficient powers to intervene swiftly and decisively under such conditions.
•	Poland adopted the *Banking Act* on August 29, 1997 concurrent with the new Act on the National Bank of Poland. The law generally conforms to EU guidelines, and provides NBP and the Commission with broad legal powers for corrective action to ensure a safe, sound, and stable banking sector. However, as noted by NBP, Polish banking supervision is vested with weaker enforcement powers than comparable supervision agencies in North American and EU countries[37]. Some of this is expected to change if amendments to banking legislation are adopted later in the year. As it stands now, the law and associated regulations spell out the requirements of banks with regard to general provisions, the establishment and organization of banks (including branches and representative offices), the safekeeping of accounts, settlements, credit and large exposures, guarantees and other off-balance sheet items, the issuance of bank securities, rights and duties of banks and their officers, the association and "amalgamation" of banks, bank capital and finances, banking supervision, bank reorganization (including rehabilitation, liquidation and bankruptcy), civil and criminal liability and penalties, and miscellaneous provisions (including achievement of minimum capital requirements and tax-deductibility related to provisioning expenses). Some of the key stipulations include the following: definitions of "core" and "supplementary" capital that are consistent with EU and

[35] Current levels of coverage are 100 percent up to Euro 1,000, and 90 percent of deposits from Euro 1,001 to Euro 11,000.

[36] Under such circumstances, the Bank Guaranty Fund assesses banks for an amount proportional to their share of total deposits for any net deficits. In the case of Bank Staropolski, this was PLN 470 million after recoveries and asset sales. Thus, for example, Pekao SA had to pay about PLN 90 million from net profits because they hold about 20 percent of banking system deposits.

[37] See "On-Site Examination Manual" at www.nbp.pl.

BIS guidelines, and which specify that core capital must be a minimum 50 percent of the bank's total capital base; bank acquisition of shares in individual companies or funds cannot exceed 15 percent of bank capital; total exposure of bank investment in companies and funds cannot exceed 60 percent of bank capital; minimum capital must be Euro 5 million[38]; capital adequacy ratios must be a risk-adjusted minimum of 8 percent according to BIS guidelines, with higher requirements for new banks[39]; total exposure to single parties on a consolidated[40] basis cannot exceed 25 percent of bank capital, although there is no specificity about nuances such as "control" vs. "ownership"; and insider loans and exposure cannot exceed 10 percent of a bank's core capital, and these have a series of restrictions and conditions to keep them small, contain risk, and enhance transparency. In addition, the legislation does not permit banks to lend if the proceeds are used to purchase bank securities of their own issue. General disclosure requirements are elaborated subject to the obligation of banking secrecy, as are penalties for legal infractions. The role of the internal audit function is also stressed in the legislation for strengthened risk management as well as regulatory compliance. On this last point, it can be noted that NBP and GINB have been mindful of some of the weaknesses that prevailed in the banking system with regard to internal controls and the development of an effective and autonomous internal audit function[41]. However, on this point, bank performance appears to be erratic, with some showing good systems and others failing to meet performance requirements. One of the amendments GINB would like Parliament to adopt regards internal controls. Over the last two years, considerable work has been done to strengthen these functions. In 1998, GINB issued special recommendations on internal controls and internal audit consistent with Principle 14 of the Core Principles for Effective Banking Supervision, to provide guidance to the banks. This has been bolstered by the substantial increase in foreign investment in the banking sector by prime-rated institutions to narrow the gap that existed between Polish and EU-based banks. However, internal controls and the internal audit function show variable performance across banks, and this translates into a weaker banking system.
• *The Trust Fund and Public Trading in Securities Act* and the *Act Establishing the Warsaw Stock Exchange* were introduced in 1991 and set the framework for the introduction of the new[42] Warsaw Stock Exchange (WSE) on July 2, 1991. This was later followed by the Bond Act of 1995, the Act on Investment Funds and Law in the Trading of Securities in 1997, the Foreign Exchange Act of 1998, ordinances on the sale of Treasury debt (including debt-equity swaps) and brokerage activity, and articles of the Warsaw Stock Exchange, by-laws and regulations which bring the operations of Poland's exchanges in line with EU directives[43] and

[38] For banks that did not fulfill the capital requirements of the new law, notification of capital deficiency to the Commission could then lead to an agreed plan to achieve the minimum target by end 1998, and in some selective cases, by end 1999. As of mid-2000, all banks appeared to have met this requirement. However, five banks had negative capital on a risk-adjusted basis.

[39] New banks are required to have minimum 15 percent risk-adjusted capital through year 1, and minimum 12 percent through year 2.

[40] "Consolidated" is defined as "a group of parties related by capital and management and incurring common economic risk." See *The Banking Act*, Article 71.

[41] See "Introduction To Polish Edition of Core Principles For Effective Banking Supervision," Warsaw, January 1998 at www.nbp.pl.

[42] The original WSE began in 1817 and was closed in 1939.

[43] Relevant EEC guidelines have included (i) 79/279 on criteria for listing on the stock exchange; (ii) 80/390 on harmonization of provisions for stock exchange listing; (iii) 82/121 on regular information published by listed joint stock companies; (iv) 89/298 on harmonization of provisions for public offerings of transferable securities; (v) 89/592

OECD guidelines. Legislation has dematerialized securities, permitted brokerage firms to become full-fledged investment banks, and allowed trading in warrants and derivatives[44]. The Polish Securities Commission (PSC) is responsible for supervising the markets. The PSC is a member of the International Organization of Securities Commissions, which has been working closely in recent years with the Bank for International Settlements to establish more effective regulatory oversight across borders in a broad range of financial services which link banks and investment firms. International standards of corporate governance, accounting and information disclosure are applied in the cases of companies listed on the WSE. This is generally true of companies listed on the smaller CeTO[45] (over-the-counter, or OTC market), although a bit less rigorously applied due to the comparatively smaller size of firms on the CeTO. Brokerages are required to operate as independent units if they are owned by banks. Poland's exchanges have a strong reputation for depository, clearing and settlement operations. More than 225 companies were listed on the WSE in June 2000—up from 83 at end 1996 and 165 in April 1998—and mutual investment funds and bonds are also traded. Listings include the 15 National Investment Funds that were listed in June 1997 and are responsible for managing about 512 companies that were "mass privatized." The NIFs have not fared very well, with values declining 7.6 percent in 1999 when the other WSE indicators generally showed more than 40 percent increases during the same period. Poland has generated large foreign inflows on a per capita basis over the last few years after poor performance in the early 1990s. Foreign direct investment (FDI) began to increase in 1996, and portfolio flows have accounted for a significant share of WSE volume/value since the early 1990s. Privatization of major blue chips has served as a catalyst for this trend. WSE is considered a highly liquid market (based on high turnover ratios), albeit small. Investors are free to transfer capital and earnings in and out of the country as long as tax obligations are complied with. The liberalization of current transactions, a function of OECD membership, assisted in these developments.

- Poland earlier had problems regarding claims on movable properties through *lien perfection*. This served as a disincentive to banks to take risk in the early 1990s, due to their inability to collect on debts that were collateralized. Poland initiated a judicial reform project in mid-1995 to review legal structures and case loads, and to strengthen *property registration* procedures and records. In January 1998, Poland enacted a new Registered Pledge Law to allow for a uniform, centralized and computerized property registration system for non-possessory pledges over movable properties. Enforcement of pledges has been possible without court assistance since 1998 in executing warrants. These changes have strengthened the legal mandate for creditors to collect on loans. As a result, improvements in lien perfection and property registration have contributed to banks' willingness to lend, including to smaller businesses and households. These improvements have also probably had an impact on loan pricing, as some of the risk of credit exposure on secured loans has been reduced. Meanwhile, a handful of debt collection firms have been established to work in this field. Most were established in 1992-93, and four of six were set up to collect on debts from abroad. There is only one firm that seems to focus on collections in the Polish market—Kaczmarski-Inkasso—and this is more likely on

on harmonization of provisions for insider transactions; (vi) 93/6 on capital adequacy of investment service companies and credit institutions; and (vii) 93/22 on securities investment services.

44 Trading in derivatives began on the WSE in 1999.

45 CeTO is the acronym for the Central Table of Offers.

behalf of merchants rather than banks. This firm had PLN 12 million in revenues in 1998 based on PLN 38.5 million in collections and 17,368 orders based on a success fee of 15 percent[46]. Thus, average orders are small, approximating PLN 2,317.

- Poland has gained experience and commercial training in specialized bankruptcy cases throughout the 1990s. However, because of excessive case loads, both *in-court and out-of-court adjudication* procedures are utilized in Poland. There is widespread criticism of judicial processes in Poland, from the private sector as well as from regulators. Commercial cases are generally heard by special divisional economic courts. These divisional courts have second-tier voivod-level courts which hear appeals. Courts enjoy fairly broad powers, including appointment of liquidators, verification of creditors' claims, and general supervision of bankruptcy proceedings. When utilized, liquidators are contracted to void specified transactions prior to liquidation, to seize debtors' assets, to inventory property, and to issue financial statements. Thus, liquidators play a more financial/administrative role that is overseen by judicial authorities. Liquidators are not required by law to possess specific qualifications or certifications. Out-of-court settlements can be reached when a majority of creditors reach a binding settlement on a reorganization plan with the debtor. In this case, the courts confirm the results without rendering judgments as long as the settlement is legally compliant. In general, the in-court process is slow. Commercial cases in Warsaw require one to two years to be heard, and another one to two years for a final judgment for the execution of payment. First-instance decisions can be appealed. There is also an independent right of judicial review of administrative actions initiated by the courts.

- The Bankruptcy Law of 1990, which amended the old 1934 law, provides the legal framework for *bankruptcy, liquidation, and foreclosure* proceedings in Poland. Bankruptcy settlements are binding when a majority of creditors agree to a reorganization plan with the debtor. At that point, the court appoints a liquidator who carries out many of the financial and administrative formalities of the reorganization under the review of the court. From 1990-96, 23,237 bankruptcies were filed, resulting in 20,370 "liquidations" and 2,867 reorganizations. The former were often restructurings that permitted companies to escape financial obligations to creditors. In fact, one of major weaknesses in the Bankruptcy Law was the low priority given to secured creditors, whose claims were subordinated to government, social security funds, and employee wages prior to collections. Recognizing these weaknesses, out-of-court conciliation procedures were initiated under the Act on the Financial Restructuring of Enterprises and Banks in 1993 to strengthen the hand of creditors in negotiations. This led to modest development of a secondary market for *liquidation and repossession* along commercial lines, which was strengthened with enactment of the Banking Act in late 1997. However, court processes are still considered bogged down in cumbersome and time-consuming procedures.

1.3 Regulatory/Supervisory

Poland's banking supervision department—known as the General Inspectorate of the National Bank (GINB)—represents one of the strengths of Poland's overall financial infrastructure and institutional capacity. The regulatory framework conforms to prudential

46 See the Book of Lists: 2000, *Warsaw Business Journal*.

guidelines rendered by the Basle Committee for Banking Supervision[47], as well as more recently with EU directives and guidelines more consistent with "universal" banking practices.

The banking supervision department of the NBP was introduced in 1989 with the break-up of the monobank system. After an initial period of crash liberalization in which Poland sought to rapidly transform itself from a centralized command economy to a market-based system, Poland introduced a more prudent approach to banking regulation and supervision in 1992 when the magnitude of banking sector problems was beginning to be realized[48]. While the initial period of supervision introduced a basic prudential regulatory framework and reporting requirements, these were not effectively implemented[49]. Since 1992, banking supervision has been focused on building capacity to contain systemic risk in the banking sector and to support NBP's larger objective of price stability. This was largely predicated on legal changes to the Banking Act in 1992, which empowered NBP to issue legally binding resolutions to which banks had to adhere. As elsewhere in the region, this was most directly illustrated in changes in provisioning requirements and loan classification standards, bringing to the fore a more accurate understanding of underlying asset value and capital adequacy. New accounting practices, valuation standards and risk weights exposed the financial and capital weaknesses of the banks, and set in motion a whole series of requirements for safe and sound banking.

Legislation in 1997 altered the role of the GINB. In one sense, it was expanded to play a major executory role on behalf of the Commission for Banking Supervision (CBS). On the other hand, its role was potentially diluted by the presence of a broader composition of the Commission through which GINB is required to coordinate its activities. While there has been reasonable

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47 This Committee is a formal part of the Bank for International Settlements, or BIS.

48 Problems existed at three broad levels in 1992. First, the structural link (e.g., banking sector developments under commercial conditions) to monetary and broader macroeconomic conditions was poorly understood because the condition of the banks was poorly understood. A prudential regulatory framework for banking was needed to help provide NBP with the underlying stability it needed to achieve its objective of price stability. Second, it was becoming increasingly clear that the large state banks—both specialized and commercial—were in poor financial condition, and that it was going to be costly to recapitalize and restructure them. NBP, the Ministry of Finance, and the government as a whole needed to have a better understanding of the magnitude of the losses to assess the potential costs and how these would be financed. Further, to avoid a recurrence, better information was needed by NBP to ensure that imprudent behavior on the part of bank boards and management would not lead to greater problems in the banking sector. This led not only to a better regulatory framework, but the adoption of an increasingly integrated approach to banking supervision, based on comprehensive policy coordination, full-scope and targeted on-site examinations, and off-site surveillance focused on regular reports on areas of greatest risk. Third, it became clear during the turbulent period of 1989-90 and thereafter that many of the smaller banks that had recently received licenses were incapable of managing banking operations in a safe and sound manner under risky conditions. (In 1989, 13 Polish banks had licenses to operate. By 1992, the number of banks had increased to 90. Most of these were very small and poorly capitalized. Minimum capital requirements were *old* PLN 4 billion, or the equivalent of about $3.5 million at the time. Thus, entry into the banking market was very easy. The number of banks superseded the capacity of NBP to properly oversee the banking system.) In some cases, this was due to the volatility of the market during the early period of "shock therapy," and the years shortly thereafter when inflation rates were still high and the political situation was unsettled. In other cases, this was due to outright corruption and fraud.

49 See Bednarski, P., "Evolution of Banking Supervision in Poland and Its Future Prospects", 1999.

50 For instance, property-related figures are not broken out into residential, commercial and other forms of property or real estate development. Differing trends may have a significant impact on portfolio quality.

51 While foreign currency values are reported and required to comply with regulations on open positions—15 percent in individual currencies, and 30 percent globally—they are not necessarily analyzed on a time-to-maturity basis or sensitized for risk. This weakens the value of off-site surveillance, and the ability to conduct targeted on-site inspections that hone in on foreign exchange risk.

coordination at senior levels of the CBS, there appear to be weaknesses in coordination at more technical and operational levels. If Poland moves increasingly towards integrated, risk-based, consolidated supervision, these weaknesses will have to be remedied. Nevertheless, overall, GINB is perceived to be effective in its oversight of the banking system. It has avoided some of the weaknesses found in many other neighboring supervisory agencies, such as inadequate internal coordination (e.g., policy, strategy, on-site and off-site), coordination at senior levels between/among differing regulatory authorities, reluctance to use on-site inspections, reluctance to apply enforcement mandates, and inability to retain competent and trained personnel. However, as noted elsewhere, these and other areas/practices can be strengthened in Poland.

Within GINB, it is believed that there could be better coordination between off-site surveillance and on-site inspection strategies and timing. Coordination with other regulators will be needed as universal banking takes hold. Enforcement mandates and penalties/sanctions are not always as strong or as rapid as they need to be, as shown in the case of Bank Staropolski. The non-privatization of some of the largest Polish banks also undermines GINB's mandate to enforce supervisory actions in a manner similar to private banks. Additional weaknesses in 1997-98 were at the technical level and rooted in insufficient information, the nature of some reporting forms[50] and methodologies[51], the need for increased training in risks associated with derivatives—mainly foreign exchange, interest rate, and pricing—and mortgage lending, and the need for more targeted inspections when risks were identified, as opposed to comprehensive examinations.

There may be inadequate information generated from banks regarding off-balance sheet risks (e.g., guarantees, third party transactions) which could undercut the ability of NBP to identify, evaluate and contain risks early enough for a targeted inspection or corrective action. On the other hand, actual exposure risk may be understated as many companies have not hedged their positions due to high transactions costs. Major risks to underlying stability are cross-ownership affiliate relationships, as with Bank Staropolski. This could be a particularly serious risk when non-regulated financial entities own banks, or when they are large borrowers from banks and supervisors lack adequate access to their financial records, preventing portfolio reviews to test for bank soundness. There could also be undisclosed risks in consumer lending and exposure to leasing finance companies. In the past, NBP has required that banks fully provision for exposure risks to leasing companies. A conservative approach has also been in place with regard to consumer lending, where the highest growth rates have occurred in bank lending. Likewise, there may be inadequate information reported to NBP from banks regarding the links between interest rate, exchange rate and maturity risk. Many banks are currently borrowing in foreign currency and lending in zloty. Reporting forms to NBP are in zloty. This conversion may gloss over the exposure some banks have in the event of a material shift in the exchange rate. However, given the introduction of a fully free-floating exchange rate, the key here is for banks to have the systems in place to manage these risks, with GINB/NBP monitoring those banks for their systems and capacity.

One weakness that appears to still be in place is the absence of repricing data on loans and deposits, particularly as the market moves to an increasing proportion of variable rate instruments in a period characterized by higher inflation rates, the risk of higher interest rates, and increasing portfolio inflows. More specific forms which show the actual currencies, exchange rates, interest rates and maturities of borrowings and loans on a weighted and time-to-maturity basis might assist NBP with its surveillance. While it is assumed that the banks themselves have all this information, the ability of NBP to manage monetary policy and CBS/GINB to focus on overall financial sector stability is partly undermined by incomplete information. **Score: 3+/4-**

- *Licensing requirements* and regulations were tightened in the banking sector in 1992 when NBP began to realize that its earlier liberal licensing policy was premature and risky. Subsequent legislation, which became effective on August 29, 1997, further tightened requirements. This included raising minimum capital to at least Euro 5 million, and a clear specification of the principles governing the internal audit function. The Commission for Banking Supervision is responsible for licensing. In keeping with international best practices and emerging global trends, the licensing process has progressed from a rules-based process based on stated requirements to a risk-based approach in which applications are evaluated based on the institution's demonstrated ability to manage risks within a universal banking context. Requirements for bank managers and members of the board, higher minimum capital, internal audit functions, business plans, and other considerations have come under more intensive scrutiny relative to the risks associated with the issuance of these licenses. In 1997-98, there was a risk that the Commission might use such a mandate to stifle meaningful financial sector liberalization and competition. However, this has not been the case. To the contrary, prime-rated foreign institutions have increased their presence in Poland, and conditions have become far more competitive as a result.

- Notwithstanding administratively cumbersome judicial requirements, relatively weak penalties, and difficulties in swiftly intervening to resolve problems associated with troubled deposit-taking institutions, the NBP has a *clear legal basis and mandate to supervise* the banks. Polish banking legislation clearly delineates the role of the Commission for Banking Supervision and its mandate for supervision of the banks. The general mandate of supervision is based on principles of cross-border reciprocity driven by EU Directives—host country responsibility, mutual recognition—with regard to cross-border banking and consolidated supervision requirements. Supervision is also based on principles of cross-sectoral cooperation with other regulatory agencies, driven by Basle Committee guidelines and recommendations for oversight of financial services—the Securities Commission, the Agency for Supervision of Pension Funds, the State Agency of Insurance Supervision, the Bank Guarantee Fund, and international counterparts. NBP/GINB work closely with BIS to ensure that practices are consistent with the Core Principles. The Commission's objective is to ensure the safety of funds held in banks, the stability of the system at large, and overall compliance by relevant institutions with the laws and regulations that pertain to the banking sector. There appear to be two major yet evident weaknesses with regard to the actual mandate NBP has with regard to supervisory enforcement. The first regards the supervision of complex institutions (e.g., diversified financial conglomerates) on a consolidated basis. The second is with regard to state-owned banks undergoing rehabilitation[52]. The first problem represents the direction in which the financial system is evolving, and will likely require a broad range of measures to amend existing legislation, to more precisely define the role and measures of the Commission for Banking Supervision (and associated supervisory entities in banking, securities and insurance), to educate judges and other legal personnel, and to provide GINB with more resolution capacity. The second problem appears less severe now, and is indicative of lingering problems of the past, namely dealing with the long troubled PKO BP and BGZ[53].

[52] As employees of NBP, bank supervisors are civil servants. While not necessarily subject to the same employment conditions as other civil servants, bank supervisors sometimes believe this status can create political complications that can weaken GINB's enforcement mandate when dealing with state-owned banks.

[53] Both banks have been financially impaired for years, although more recent financial results have been positive. Along the PZU, the major insurance company, these three institutions represent the biggest potential losses

However, the privatization of PKO BP is likely to require some kind of financial bail-out of the large stock of old housing loans still held by the bank. According to NBP, about a third of total housing loans were irregular at end 1999. If interpreted as loss, this would equate with PLN 3-4 billion, equivalent to about 6 percent of PKO BP assets, all of PKO BP capital, and about 0.5 percent of GDP. In general, supervision has a legal mandate to ensure the solvency and liquidity of the banking system, to ensure banks operate within the laws and regulations in effect, to issue recommendations for corrective action, to suspend or modify banking operations, and to revoke bank licenses if needed. However, the Bank Staropolski affair showed that the process is not easy or smooth for NBP/GINB, nor sufficiently effective. This is instructive as Bank Staropolski was not a large bank or deposit-mobilizer. Importantly, GoP has permitted NBP to issue regulations (subject to *ex post* review) in support of effective supervision, rather than having to rely on the legislative and judicial branches for repeated regulatory mandates. As a result of this relative autonomy, NBP/GINB is able to update the regulatory framework in keeping with recommendations and improvements from the Basle Committee, including timely alignment of the Polish prudential framework with the prevailing international framework emanating from the Basle Committee process[54]. However, more will need to be done to redress supervisory weaknesses regarding diversified financial conglomerates and their investments/transactions with affiliates.

- The *organizational structure* of banking supervision includes five departments, all of which are managed by/within the autonomous GINB. These are Licensing, Supervisory Policy, Banking System Off-Site Analysis, On-Site Examinations, and Cooperative Banking. GINB carries out supervision on behalf of the Commission for Banking Supervision. The Commission's basic responsibilities are to ensure banking activity is conducted in a manner that ensures the safety of deposits, to supervise compliance of banks with prudential requirements, to draft rehabilitation programs for troubled banks, and to suspend management and place banks under administration when conditions warrant. GINB serves as the implementing agency for the Commission to enforce its banking supervision mandate. GINB's basic responsibilities involve the monitoring of banks' ownership structures and adequacy of management, assessing the financial soundness of banks, and drafting prudential regulations to ensure banks' level of risk-taking is prudent within the context of their capital and with regard to the banking system at large. GINB has about 500 employees, of which about 300 are assigned to on-site supervision. This represents an increase of more than 150 employees since 1998[55], and far lower head count in the early 1990s. In addition to on-site supervisors, there are about 45 assigned to off-site surveillance, 45 to the policy and legal departments, 30 in

to the financial sector were they to be closed. In the banking sector, PKO BP and BGZ account for a sizable portion of deposits. They are also sometimes the only bank in operation in certain areas, although this is likely to be less of a problem in the future given retail expansion by other banks, and the existence of a credit union movement that did not exist until 1992-93. In insurance, the privatization of PZU has already begun, with Eureko emerging as the key strategic investor in Poland's largest insurance company, notwithstanding recent questions about how the Treasury is handling the privatization process.

54 For instance, since October 1999, the Basle Committee on Banking Supervision has issued reports, recommendations and guidelines on the public disclosure of trading and derivatives activities, methodology for the implementation of Core Principles, cross-border communications among supervisors, Y2K information, capital adequacy and market discipline, corporate governance, capital charges for market risk, intra-group transactions and exposures, risk concentrations, banks' interactions with highly leveraged institutions, internal ratings systems, liquidity management, IAS, and credit risk modeling.

55 See INSIGHTS, Barents Group LLC newsletter, Spring 1998.

licensing, 20-30 in cooperative bank supervision, and about 50 employees providing additional support services. GINB has been challenged by staff leaving for the private sector, constituting a major expense in terms of training and putting more pressure to develop attractive overall compensation packages and working conditions. One of the needs NBP/GINB will have in the future is a more comprehensive human resource plan mapped out to attract and retain needed personnel, particularly as supervisory challenges become more complex[56].
• *Penalties* for regulatory non-compliance by bank managers and employees can be assessed, as they can for board members as well. This includes penalties for violations of insider loans, bank lending to parties for the latter to purchase shares in the former, divulging confidential information, and other violations of prudential regulations. Penalties can also be assessed on companies mobilizing deposits without a banking license with the intention of lending. It is not the policy of NBP/GINB to divulge when penalties are assessed. However, GINB is submitting a proposal to parliament to toughen penalties and sanctions. These would include an increase in the financial costs to bank managers.
• The Accounting Act of September 29, 1994 introduced new accounting principles that largely conform to the EU Fourth Directive. Since that date, there have been amendments from 1997-99 that changed 13 items in the 1994 legislation. These changes were introduced to remain consistent with EU and international standards. Prior to 1994, most statements were cash-based and prepared for tax and Central Statistical Office purposes. The 1994 Act, along with other legislation that applies to the financial sector, introduced standards of *disclosure* that are adequate at the major banks and insurance companies[57], as well as for firms listed on the stock exchange. This includes consolidated statements, and notes to amplify on assumptions that underlie financial statements so that these statements are reliably and clearly presented in a timely manner. According to the Commercial Code, disclosure requirements for joint-stock companies—which includes most large banks and companies—include delivery of statements and associated reports to shareholders at least two weeks prior to the annual shareholders meeting. Shortened versions of these statements and auditors' opinions need to be published in the Polish Monitor. Additional disclosure requirements apply for reporting to tax authorities and the Central Statistical Office. Thus, at the upper end of the market, Poland's accounting standards are serving as a catalyst for increased transparency and disclosure for the market, for regulators, and for management. This is helpful for market development, as well as for effective banking supervision. However, there are questions about the timeliness and completeness of information presented, particularly if only at the holding

[56] See "Strengthening Bank Supervision—Final Report," Barents Group LLC, March 1, 2000.

[57] There were reservations in earlier years about some of the potential risks associated with the statements of PZU as well as from PKO BP and BGZ. However, they are now audited by Big 5 firms. Risks in accounting and audit appear to be at the smaller-scale level, with Bank Staropolski and Polisa Insurance serving as examples of loss-makers that received favorable audit reports by local firms. In the future, it is expected that standards of internal management accounting as well as external financial accounting will be tightened to avoid a recurrence. At a minimum, regulations are in place for the banks and insurance companies to provide adequate disclosure of financial information based on audited statements, and conforming to IAS and the EU Fourth Directive. Based on discussions with bankers and others active in the market, there is a general view that information disclosed is much closer to EU standards in financial services than in other sectors of the economy.

company level. There are also questions about the level of disclosure from smaller private firms. Firms with sales/income[58] below Euro 400,000 are not required to file IAS statements due to the costs of preparation. In terms of banking, this means that most firms do not meet the information and disclosure requirements applied to larger firms. This adds to the risk of credit exposure to these firms, which will either sustain higher pricing for credit to these firms, or potentially expose banks to imprudent levels of risk. While this is not uncommon in commercial finance, these risks need to be accounted for when there are direct or indirect ties to deposits. Since 1998, as banks have increasingly competed for new markets in the household and small enterprise sector, the pricing of loans has been more affordable for borrowers. Nevertheless, because of risk and higher per-unit administrative costs, these rates are still higher than in the corporate sector. For banking supervision, it will be important to identify if the net spreads on these loans are sufficient to compensate for the risk, and if stricter information requirements should be applied for banks to better contain these risks. Moreover, the audit profession will need strengthening so as to present more reliable information. In the past, Polish auditors have generally focused on tax accounting, and few are chartered in IAS. Improvement in the profession may help reduce some of the information weaknesses that increase levels of risk and add to interest rates charged on loans to SMEs and households.

1.4 Payments System

Poland's payments system has undergone considerable modernization in the last two years. Three years ago, about half of all banks were participating in the fully electronic system. However, smaller banks were constrained by their own internal capacity and limited investment resources. Further, they often benefited from float in a higher interest rate environment. Since then, major investment has been put into electronic systems, and bank branches are all fully linked to the system. The proportion of paper transactions has diminished, and clearing and settlement take no more than three days. While not real time, this compares with earlier approaches that relied on paper and courier services, high levels of manual inputting, and generally slow processing of transactions.

Investment in electronic capacity and more modern payments systems has made it possible to accommodate the banking sector's ambitious plans to increase credit and debit cards, point-of-sales terminals, ATMs, and a general increase in electronic volume. In terms of risk, the earlier system presented no systemic risk because settlements were conducted on a net basis, and did not occur unless funds were available from the debtor bank's account held at NBP. With electronics, the same approach can be applied with a greater degree of accuracy. The latter is due to capacity for more precise liquidity management practices and routine safeguards built into the system. Until recently, most banks estimated their funds at daily closing and maintained surpluses at NBP for insurance. This was particularly burdensome to the banks during restrictive monetary periods. Today, banks are able to tally their accounts faster and more precisely, thus retaining funds for their own earning asset accounts. Any security risks—financial, managerial or operational—are reported to be manageable.

Score: 3+

[58] These are net sales of goods and finished products plus financial income.

• Poland was burdened by a slow and somewhat paper-intensive *payment, clearing and settlement* system until 1997-98. Since then, major strides have been made in modernizing this system. Today, 100 percent of payments are cleared and settled within three days. As recently as 1998, a network of couriers was used to clear documents for nearly half of Poland's banks[59], adding to processing time, delays, float, and general inefficiency. However, movement towards electronic banking was already beginning to take shape, as a growing proportion of banks were becoming members of the fully electronic system—ELIXIR, which came on line in September 1995. Since 1998, Poland's banking sector has made significant strides in this domain. With advances in software and telecommunications capacity, all bank branches are now able to receive electronic transactions. This was spurred by the government requirement that all pension payments be made electronically, and that all tax payments would eventually be done in electronic form as well. Even the nascent credit union movement is connected electronically, as are cooperative banks. There has been a substantial increase in new services, mostly in the form of direct debits and direct deposits. The overall network has expanded to include 3,726 ATMs and 8.2 million plastic card holders. This represents performance in excess of original goals mapped out by the industry in 1997-98[60]. Electronic payments are mandatory for the newly revised pension system[61], providing added impetus to develop a common electronic banking network. Tax payments will also be run through the banks electronically. Securities transactions will also add significantly to volume over time. In general, the system is now more efficient and standardized, and this has served as a catalyst for banks and other institutions to provide Polish businesses and households with a variety of new financial services. From a risk management position, the streamlining of settlement procedures and overall electronic improvements in the system help with liquidity management. In the long term, Poland's payment and settlement system is expected to be fully compliant with EU requirements by the time of accession, including on the finality of settlement, Real Gross Time Settlement (the TARGET system), large value transactions, and security issues.
• *Management, MIS and technology* development related to payments systems are considered sound. KIR introduced a "switch" capability in 1998 that permitted banks to move to the clearing system with all electronic transactions, while changing electronic transactions to paper form for those branches unable to receive electronic transmissions for clearing. This has accelerated the payment and settlement process, bringing the duration of transactions to no more than three days. By late 1998, about two thirds of transactions (value basis) through the banking system were electronic. By end 1999, this was estimated to have reached about 75 percent. Internal systems, procedures and controls have changed to accommodate the new electronic orientation. For instance, work has been done to standardize account numbers and formats. New technologies and systems have provided the banks with the increasing benefit of electronic bank transfers, although some of the smaller banks are constrained by limits on technical capacity. However, this has been overcome by the growing presence of systems

[59] Some of these banks also participated in the limited electronic system available—SYBIR, which came on line in April 1993.

[60] According to the Polish Banking Association in 1998, the banks hoped to have links to 150,000 point-of-sales terminals, 3,500 ATMs, and 6 million plastic card holders by 2000.

[61] This was expected to represent volume of about 2 million payments per month, starting in January 1999. See "Payment System—Final Report," First Washington Associates, June 30, 1999.

integrators and hardware/software companies in the Polish market place with liberalization and competition in the telecommunications sector.

1.5 Accounting

Poland adopted the Accounting Act of September 29, 1994 to bring the country's accounting standards more in line with IAS and the EU Fourth Directive. Prior to this legislation, most statements had been produced for tax purposes and for the Central Statistical Office. Accounting regulations are waived for public sector entities and small businesses of any sort with net sales of goods and finished products plus financial income from the preceding year of less than Euro 800,000. Businesses with no more than 50 employees on average throughout the year, with total assets of no more than Euro 1 million, and with ordinary income of no more than Euro 2 million are permitted to prepare simplified statements. In Poland, this amounts to about 2.5 million businesses. However, other companies are expected to comply with standards, which are more rigorous as the size of the firm increases.

All major banks are required to prepare statements according to IAS, as are insurance companies and all companies listed on WSE, irrespective of income figures. This includes the preparation of consolidated financial statements. In the case of larger firms and firms with foreign participation, statements are expected to conform to IAS and are prepared with the assistance of international accounting firms based on International Standards of Audit. This includes consolidation standards applied to intercompany balances and unrealized gains/losses[62] for subsidiaries and associated companies[63]. Notes are used to provide needed explanations underlying balance sheets, income statements, and for larger companies, cash flow statements. These explanations include but are not restricted to depreciation schedules and the impact on fixed asset values, collateral in assets owned by the company, an analysis of share ownership, movements in capital, reserve and provision accounts, creditor maturities, contingent liabilities, tax reconciliations, information on nonconsolidated joint ventures, and loans/compensation to board members and directors.

In addition to being a standard for larger firms or being prompted by regulatory requirements in the financial sector, IAS has been a fundamental element of valuations, due diligence, and investment decision-making (both for direct investment and portfolio investment) since Poland began opening its markets. Thus, Poland's accounting standards are evolving increasingly towards international standards.

However, numerous weaknesses remain in Poland's accounting framework, some of which may point to potential risks for bank portfolios. In many cases, accounting is still conducted on a tax-oriented cash basis rather than on an accrual basis, particularly for small businesses. This is more the result of years of tradition rather than the fault of the new framework. However, it does represent a tiering of the market, differentiated by firm size. What this provides is a basis for smaller firms to understate income or overstate expenses to avoid tax payments, whereas larger firms have an incentive to overstate assets or understate liabilities to increase access to secured

[62] Financial accounting standards account for unrealized income/gains as deferred income, while unrealized losses are recognized. This represents a more prudent standard than is commonly practiced. Meanwhile, tax accounting standards only focus on realized gains and losses.

[63] Beginning in 1999, holding company statements of firms listed on the WSE had to be presented semi-annually on a consolidated basis.

loans. There are also problems related to the timing of consolidated statements.

All the major international accounting firms have been active in the Polish market since 1990. Meanwhile, there are many more Polish accounting firms, although they tend to be smaller in scale, relatively new, and unable to provide many of the financial advisory services that are needed for ordinary Polish companies to strengthen management and competitiveness. What is lacking structurally in the profession is a "middle-market" segment of the accounting profession which is less costly than Big 5 audit firms, yet more sophisticated than most existing Polish firms.

It was the opinion of some international auditors a few years ago that there was a lack of political will on the part of the Ministry of Finance and the Polish Institute of Chartered Auditors to introduce national standards that would be universally accepted for widespread use[64]. Today, it is appears there is consensus to move forward with a revamping of accounting legislation, and to strengthen accounting and audit standards. Changes are expected in related-party transactions, leasing, deferred taxation, and general standards of audit to ensure accurate financial reporting. These are all of critical importance to bank exposures and portfolio quality. However, it will also take time. The demographics of the profession point to the need for new entrants and significant (re)training of existing capacity. **Score: 3-/3**

- The authorities have shown steady movement to ensure that *international accounting standards are consistently applied* in the annual reports of "large" enterprises[65], and all major banks and insurance companies. Considering that the EU just recently issued a statement calling for the adoption of IAS by 2005 by all of its member states, Poland has made reasonably good progress in this area. This trend has been in place for years, and has been particularly true for the blue chip sector of the economy, as listing on the WSE requires detailed information that conforms to IAS. The OTC market generally applies IAS as well based on Securities Commission standards, approved auditors, regular reports, and mandatory annual audits. In general, this has played a role in providing confidence to outside investors in the underlying quality of listings on the exchanges. However, most Polish companies are either exempt from IAS filings, or are only required to file simplified versions of financial statements. There is also the question of cost, as most enterprises can not absorb the cost of hiring an international accounting firm. If there is a major weakness in the structure of the accounting and audit profession in Poland today, it is the major gap in the "middle market". As SMEs grow, they will need more sophisticated services and advice than they currently get from Polish accounting firms. Yet, the Big 5 will remain prohibitively expensive for many of these firms. Thus, over time, companies will likely need a better match of accounting and audit services than they can currently and feasibly obtain. However, with regard to the banks and large insurance companies, IAS appears to be applied in most cases.

- The Banking Act is strict in terms of *reporting*, requiring banks, bank groups and financial holding companies to report to supervisory authorities on a regular basis. This is specified in the Act as part of the particular duties of banks and obligations of banks with regard to banking supervision. Banks have frequently relied on international auditors to assist with preparation of needed annual reports and financial statements, and these firms are credited by bank managers as having provided significant assistance. All of the major banks use the Big 5

[64] See "Doing business in Poland," Price Waterhouse, October 31, 1997.

[65] This applies to firms with greater than 50 employees, fixed assets exceeding Euro 1 million, and revenues exceeding Euro 2 million.

	firms for annual audits. In the past, there were thought to be weaknesses in some of the information produced—overvalued assets, understated liabilities—partly resulting from an undeveloped internal audit function, weaknesses in supervisory and management board oversight, and inadequate risk management practices. The banks are strengthening these functions and practices for sound business reasons as well as for regulatory compliance, partly with the help of the larger accounting firms. Changes to the Accounting Act are expected to include related-party transactions, leasing, insurance, deferred taxation, and general standards of audit to ensure accurate financial reporting. This will affect banks by improving the quality of information presented by the corporate sector. However, lending to SMEs will continue to be heavily secured for the foreseeable future[66].
•	There are *accounting training programs* and institutes in Poland for international as well as Polish accounting standards. IAS is largely based on the EU Fourth Directive. Some of Poland's smaller (non-Big 5) accounting firms are certified in IAS as well as local standards. However, most domestic accounting firms are small, with only one to two offices on average. The profile of the average Polish accounting firm is 18 full-time employees, of which 11 are accountants, two are auditors, one to two are tax advisors, and maybe one is a lawyer. They are also new, having become established in the 1990s. There are more than 6,000 auditors in Poland. The Polish Institute of Chartered Auditors has 2,500 members, of which the average age is about 55.
•	Poland has more than 33 *accounting firms*, including all of the Big 5 and four mid-sized accounting firms from abroad, as well as at least 24 Polish firms[67]. The Big 5 all established operations in 1989-90. Based on end 1998 figures, revenues of PWC, Ernst and Young and Arthur Andersen ranged from PLN 105-164 million, or about \$35-\$40 million on average. The composition of fees is primarily driven by audit and accounting activities, ranging from 45-60 percent. Tax-related work accounts for an additional 10-35 percent of fees, and consulting and other activities account for the balance. All of the Big 5 engage in mergers and acquisitions, due diligence, legal and management consulting work. Total professional staff range from 218 at Deloitte Touche to 658 at PWC. About half to two-thirds of professional staff are auditors, of which the majority is Polish. Another four mid-level firms from abroad are also located in Poland. These firms are much smaller by head count and revenues/fees. As Poland's economy expands and many SMEs grow, it is anticipated that this mid-section of the accounting and audit profession will grow. However, for the time being, this represents one of the weakest parts of the accounting structure. The absence of firms that are more competent and exposed to IAS than most Polish firms, and yet are not as costly as Big 5 firms, represents a gap in the market place that will need to be filled over time. Most of these firms appear to be generating a majority of their revenue from audit and accounting work, as opposed to tax and other activities. This is unchanged from trends in 1996. Meanwhile, there are also at least another 24 *Polish accounting firms*, mostly engaged in accounting, audit and tax work like their international counterparts. At end 1998, revenue figures indicated that about 80 percent of fees were derived from accounting and audit work. Thus, unlike international trends, these firms have not moved on to increase their proportion of revenues

66 New firms generally obtain unsecured loans only about 3 percent of the time. See Bratkowski, Andrzej, Irena Grosfeld, and Jacek Rostowski, "Investment and Finance in *de novo* Private Firms: Empirical Results from the Czech Republic, Hungary and Poland," Center for Social and Economic Research, Warsaw, 1998.

67 Figures on the accounting profession are derived from the Book of Lists: 2000, *Warsaw Business Journal*.

from management consulting services, although some of the local accounting firms also provide legal services. These firms tend to be very small, with total revenues among reporting firms at PLN 32 million in 1998, or about PLN 1.3 million per firm. This is about 1 percent of the revenue generated by Big 5 firms. Weaknesses at local accounting firms include a traditional cash- and tax-oriented focus, a reluctance to point out when firms are in deep financial trouble and would require a qualified statement, and limitations on the array of services they can provide. This will change over time as the demographics of the profession change. Recent problems at Bank Staropolski and the Polisa insurance firm will likely serve as a catalyst to tighten up on accounting and audit standards. In both cases, these institutions used Polish accounting firms for accounting and audit purposes.

1.6 Rating Agencies/Systems

All the major international rating agencies have been active for several years in the Polish market. Poland's credit ratings on currency as of May 2000 were generally favorable and investment-grade. These were A2 by Moodys, A+ by S&P, BBB+ by Fitch IBCA, and A- by Duff & Phelps. A domestic rating agency—CERA—was established in 1996, but its efforts have been partly constrained by information flows, concerns about confidentiality, and less enthusiasm exhibited by shareholders than originally expected. It has been able to attract Thomson Bank Watch as a strategic investor, and this might enhance its credibility over time (although initial impressions are less than overwhelming).

To date, CERA has rated about 15 securities to be issued to the public, including company issues and municipal bonds. CERA has also rated another 12 issues on an unpublished basis. About half have been for banks. CERA is optimistic that it can play a role in the domestic banking market by using its ratings methodology to assist institutions in their assessment of counterparty risk. CERA also expects the mortgage bond and commercial paper markets to grow. **Score: 3**

- Poland has received ratings from at least four major *international rating agencies* on a regular basis for several years. Credit ratings for Poland are generally favorable. Poland's ratings held during the period before and after the zloty became a free-floating currency, as opposed to the crawling basket peg that was in place until April, 2000.

- There has been a *domestic rating agency*—the Central European Rating Agency, or CERA—for a wide range of instruments issued by banks, companies and municipalities since 1996-97. As of mid-1998, CERA's efforts were undermined by insufficient disclosure of information, and limited participation from its shareholders. Disclosure has been improving with WSE-listed companies and with municipalities since then. However, accessing sufficient meaningful bank information has been more difficult for CERA, notwithstanding the shareholder structure of CERA, which are primarily Poland's main banks along with the Polish Banking Association[68]. The banks appear to have had limited willingness to disclose information, particularly if they are able to access syndicated loans from abroad. In the case

[68] Other shareholders include Thomson Bank Watch as a strategic investor (45 percent), the Pioneer mutual fund, and one of the brokerages.

of those listed on WSE, the major banks feel they already disclose significant information to be listed on WSE. However, in light of recent BIS emphasis on the use of external rating agencies to assist with market evaluations of the financial condition and comparative risk of institutions, there is a possibility that GINB will be a catalyst for banks to employ CERA as part of its compliance requirements in the supervisory process. Apart from CERA, the main Polish banks and the Polish Banking Association were planning to develop a credit information bureau to be utilized by the banking sector for delinquent borrowers. This started operating in 1997, and represents a fairly simple and straightforward data base of interest and principal service performance. As for banks, GINB developed a more formal CAMELS rating system for banks in 1998-99. The system was tested on a mix of about 10 banks, focusing on risks associated with credit, interest rates, liquidity, foreign exchange, and internal controls. However, these findings are kept confidential by NBP/GINB authorities. Credit rating information on individuals and companies has generally been limited due to strict concerns about confidentiality. This was becoming an increasingly important concern in 1998 due to the quickly rising share of consumer credit found in bank portfolios, and the growing demand for credit from small businesses which pay higher spreads on loans to banks but which have little or no documented credit history through the banking system. Without adequate disclosure of useful information on the credit worthiness of these borrowers, the incompleteness of information meant increased risk of credit exposures in banks' portfolios. The decline in interest rates and increasing competition among the major banks for blue chip business in Poland led to an increase in lending to small businesses and consumers. Those trends have continued since 1998, as consumer credit has continued to show major growth—in 1999, consumer loans increased by 47 percent as compared with only 19 percent to the corporate sector and 26 percent overall to the non-financial sector. Irregular loans to this segment have stabilized at about 7.0-7.5 percent, still lower than the 15.4 percent irregular loans due from the corporate sector[69]. Although this was not the only reason for declining banking sector profits in 1999, it may have represented a contributing factor.

1.7 Financial Media

No particular effort was made to assess the financial media. However, there are several newspapers that report daily and weekly monetary and financial information. Market research firms conduct surveys for continuous feedback from the public. There are also many English-language journals. Media coverage is generally considered responsible. An effort has been made through Mediabank (in which the Polish Banking Association has a 33 percent stake) to provide greater information to radio, television and journals on developments in the banking industry—including product offerings, new lending trends, and other news that is relevant to the public. PBA believes this has contributed to higher customer satisfaction ratings with the banking sector. There are also many web sites with information on the banking system and economy. Meanwhile, NBP and the Monetary Policy Council have pursued more open communications strategies to ensure the public is better informed about economic targets, monetary policy, and likely movements in interest rates and other measures. These have been reported broadly in the financial media.

Insufficient Basis for a Score

69 See "Summary Evaluation of the Financial Situation of Polish Banks: 1999," NBP, April 2000.

1.8 Professional Associations

There are 33 Chambers of Commerce in Poland, with a total of 6,655 members, or about 200 on average[70]. These associations are generally organized along regional, bilateral, or trade/specialized areas of focus. In the third group, sectors covered include agriculture, mining, industry, furniture, SME crafts, printing, telecommunications and pharmaceutical producers.

In addition, there are several professional associations in Poland for financial sector individuals and groups. Among the largest are the Polish Banking Association (PBA) and the Polish Chamber of Auditors. The PBA remains engaged in the drafting of legislative initiatives, and enjoys observer status at meetings of the Committee for Banking Supervision. PBA is engaged in a number of initiatives that have accelerated market development in the banking sector. Recent initiatives have included a key organizational role in promoting development of the payment and settlement system, support for the local credit rating agency (CERA), development of the credit information bureau being launched in 2000, and coordinating input on a regular basis from the banks to NBP with regard to regulatory and supervisory initiatives. Other PBA initiatives dating back to 1998 and earlier include a shareholder role in establishing the national clearinghouse (KIR) for bank settlement[71], development of the TELBANK system[72], and managing a modest data bank on delinquent borrowers[73]. It is specified in the Act on the National Bank of Poland that a representative of PBA participate in meetings of the Commission for Banking Supervision on matters that relate to regulation and supervision in the banking sector, including when CBS discusses issues related to safety and soundness[74]. Thus, PBA has been and is considered important in coordinating input to/from banks and legal/regulatory authorities. Its membership is voluntary, yet it includes all banks as members as well as some of the larger cooperative banks.

The Warsaw Institute of Banking, established in 1992, is closely associated with the Polish Banking Association, and has played a leading role in coordinating some of the technical assistance and training activities that have been financed over the years by donors. In 1997-98, this had included the training of more than 3,000 people working in more than 50 Polish banks. These numbers have grown in recent years, and this has served as a complement to other business and training institutes that have provided some of the human capital of the banking industry.

In the accounting and audit profession, the Polish Institute of Chartered Auditors has 2,500 members, and is now providing some post-qualification training and examinations for ongoing professionalization through its institute. The Chamber is also responsible for licensing auditing firms. The Institute has introduced post-qualification training and examinations as part of its efforts to contribute to the strengthening of the audit profession. **Score (for PBA): 4**

1.9 Academic

[70] Figures on Chambers of Commerce are derived from the Book of Lists: 2000, *Warsaw Business Journal*.

[71] Unlike most other payment and clearing systems in the region where the central bank is wholly or partly responsible, NBP has not been directly involved in clearinghouse activity in the banking system.

[72] This system provides clearinghouse, point-of-sales, and electronic banking services.

[73] This data base had 175,000 names as of April 1998. Only the names of borrowers and the banks are included in the data base. This will be expanded later in the year with development of a more complete credit information bureau.

[74] See *The Act on the National Bank of Poland*, Article 25.

There are currently at least 32 business schools in Poland, with more than 125,000 students enrolled[75]. This would mean the addition of at least 30,000 trained entrants to the work force each year, assuming the average program lasts for four years. Most of the schools were established in the early or mid-1990s, although some were established earlier, including one founded in 1816 (by Tsar Alexander II). No particular effort was made to assess the quality of academic institutions in Poland, nor was there a systematic effort to speak with business/management school officials. However, Poland continues to benefit from many schools, institutes and think tanks that are able to make a significant contribution to banking sector development. Most have cooperation agreements with economics, business, finance, management and marketing programs in Western Europe and North America. However, there is a question of whether these schools are able to produce enough graduates to meet the growing needs of the financial and corporate sector for skilled, knowledge-based employees. This risk may be compounded in the future as EU countries, North American markets and other economies seek to attract skilled personnel. Most large financial institutions are investing heavily in training, and recent figures from NBP indicate that personnel costs are going up, including salaries[76].

Insufficient Basis For a Score

1.10 Miscellaneous

In Poland, overall electronic and telecommunications capacity is rapidly increasing to compensate for what was one of the least developed systems in the region. Investment in these areas is clearly evident in the banking and financial sector, as many banks are spending to improve their internal information and communications systems for better management and the provision of a wider range of services. Part of this has been prompted by NBP, which required electronic reporting of UBPRs back in 1997.

Poland started the 1990s with one of the least developed telephone systems in Europe. Even by ex-communist standards, the system was poor—only 8 percent of the population had access to main-line telephone service, and service levels were poor. Even in 1996, there were only 169 telephone mainlines per 1,000 people in Poland[77], which lagged the Baltic States[78] and were about on par with most of the European part of the former Soviet Union[79]. Today, it is estimated the number of mainlines per 1,000 has increased to more than 219[80]. Mainlines are still short of EU standards, although the gap is narrowing. The government has pursued a program to modernize infrastructure in advance of privatization of the major telecommunications company, TPSA, which was wholly state-owned until 1998, when it sold 15 percent to the public in an IPO. More recently, GoP announced that an additional 25-35 percent will be sold to France Telecom and Kulczyk Holdings. Additional competition has been introduced for long-distance connections

75 Figures on business schools are derived from the Book of Lists: 2000, *Warsaw Business Journal*.

76 According to NBP, average salaries for bank personnel went up in 1999 at both majority Polish and foreign banks. At the foreign banks, average monthly salaries increased from PLN 3,075 to PLN 3,551. At Polish banks, salaries increased from PLN 1,975 to PLN 2,577.

77 See *World Bank Atlas*, 1998.

78 Estonia, Latvia and Lithuania had 299, 298 and 268 mainlines per 1,000 people, respectively, in 1996.

79 In Belarus, Moldova, Russia and Ukraine, the range was 140 (Moldova) to 208 (Belarus).

80 TPSA figures as of end 1998, as cited in The First Polish Economic Guide: 2000, Common Europe Publications, Warsaw, 2000

as well as for local phone services, although TPSA remains the giant with 8 million fixed-line subscribers. Its leading competitor appears to be Polska Telefonia Cyfrowa, a subsidiary of Elektrim that is operating in the mobile phone market, with 1.8 million cell phone subscribers. However, as of early 1998, private companies only serviced 170,000 fixed line telephones in 31 of 49 voivodships, as opposed to TPSA's 7.5 million telephones in all 49 voivodships[81]. Investment requirements of $1 billion or more per year for network expansion were greater than the resources that TPSA could provide. For this reason, GoP moved more quickly with liberalization and the introduction of more competition in the telecommunications sector over the last two years. This has resulted in more than 30 major hardware, software and systems integration companies that have filled much of the gap and helped Poland advance in this critically important sector. Postal services appear adequate, as does safekeeping from a physical and logistical standpoint.

Part of the investment made by banks has been to strengthen their electronic systems for increased protection, particularly as ATMs, point-of-sales terminals, debit-credit cards and other features have been introduced more energetically in the last two years. GoP and NBP have also played a pivotal role, particularly with regard to Y2K preparations, reporting requirements, and pension payment flows. The recent announcement by Citigroup of its plans in e-banking serve as a harbinger of the future[82], with a significant expansion of internet banking and e-based commerce on the horizon. Already, this is in evidence with newly introduced retail networks from Bank Handlowy and BIG Bank Gdanski. **Score: 3+**

- Poland introduced competition in the *telecommunications* sector in 1996 when it awarded GSM licenses to two consortia. Along with adoption of a plan to privatize TPSA, the fixed-line monopoly, this commenced the process of demonopolization of the telecommunications sector. The result has led to increased investment and improvements in telecommunications system capacity and networks in Poland. Outgoing phone calls have increased dramatically in recent years, reflecting improved capacity and investment in infrastructure and the growing link between Poland's economy with that of Europe and other markets. Improvements in telecommunications capacity represent one of the major changes since 1997-98. Earlier sluggishness on this front slowed modernization of the payments system and general modernization of the banking system. This raised doubts about whether Poland would have adequate capacity in the coming years as ATMs were expected to increase to 3,500 and plastic card holders to 6.5 million by 2000[83]. At end 1999, those numbers were more than 3,726 and 8.2 million, respectively[84], indicating that Poland was able to overcome these challenges, largely due to a more open and competitive market.

- The decision to move forward with the *privatization* of TPSA was adopted by the Council of Ministers in 1996. The original plan anticipated a 20 percent privatization in 1998 that would generate $2 billion. Full privatization was expected by 2000. However, as of mid-2000, only 15 percent of TPSA had been privatized. A consortium of France Telecom and Kulczyk Holdings are on track to obtain an additional 25-35 percent of TPSA by end 2000. Thus, while a bit behind schedule, the privatization of TPSA is generally moving forward according to plan. The targeting of privatization proceeds to reduce the fiscal deficit is serving as a driving

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81 This reflected the old administrative system that was reformed in 1999. See *Polish News Bulletin*, 23 April 1998.

82 See Oxford Analytica, June 19, 2000.

83 These figures were from the Polish Banking Association in 1998.

84 Based on survey conducted by the Banking Education and Research Foundation.

	force in keeping to the privatization schedule. TPSA is valued at roughly $10 billion based on current market values, and has 8 million subscribers. This makes it one of the largest telecommunications companies in the region.
•	Much of the advancement in the telecommunications sector has been integrally linked to development of the *computer and internet market.* As of 1998-99, Poland had more than 28 hardware and software producers, at least 29 internet service providers, more than 39 systems integrators, and at least 26 telecommunications operators and equipment producers[85]. Among hardware producers, Optimus is the largest, with 1998 revenues of PLN 660 million. Products in this segment include monitors, computers, servers, graphic stations, printers, electronic cash registers, medical equipment, and mass storage devices. Among the software producers, the two largest are Prokom and Softbank, with PLN 375 million and PLN 244 million in 1998 revenue, respectively[86]. On average, software companies have 183 employees. Many of the investors are foreign, including some of the major names in the sector. Banks and insurance companies are major clients of telephone equipment producers, while many of the banks and insurance companies are owners of systems integrators.
•	The *postal system* is considered adequate. There were 7,500 or so post offices in Poland in 1997, of which 300 were computerized. By 2000, it is assumed that the postal system is more electronically-oriented than in 1997. Consumers still use the postal system for transactions, although electronic banking and enhancements in the payments system can be expected to reduce this role over time. However, in many rural areas where the level of banking services is less abundant and competitive, it is likely that the postal system will continue to make transfers and provide confirmations. In 1997, the post office was the single largest processor of payments in Poland. It had its own bank, and used 14 other banks for these services.
•	No effort was made to review the *safekeeping* practices of banks. In the future, the issue of money laundering, the operational soundness of banks' IT and MIS, and other security issues are bound to emerge. However, to date, no major complaints have been made about the safekeeping features of the banks or the payments system. Until the more recent move to electronic transactions, there was criticism of the cost of float resulting from the manual, paper-driven payment and clearing process. However, in general, practices are considered safe. Systemic risk is not considered likely through the payments system because of the system's ability to block accounts in the event of inadequate payer liquidity. While there is the risk or mistaken payments and hacking, security issues that have been identified to date are reported to be manageable.

[85] Figures on telecommunications companies are derived from the Book of Lists: 2000, *Warsaw Business Journal*.

[86] Both of these have investment from Bank of New York.

II. ECONOMIC FACTORS AND INDICATORS

Poland's economy has been evolving into a private sector-oriented system in terms of ownership, employment and contribution to GDP for the last several years. While much of industry remains in state hands[87] and agriculture needs to be modernized, the Polish economy has grown over the last several years on the strength of its private sector. This includes more than 5,000 privatized companies[88] that have generated substantial privatization proceeds over the last three years[89] equivalent to 1.3 percent of 1998 GDP and 2.2 percent of 1999 GDP.

Major privatizations concluded or ongoing over the last few years have involved Pekao SA (banking), LOT (aviation), PKN Orlen (petrochemicals), TPSA (telecommunications), PZU (insurance), and power sector entities. Poland has seen more than 2 million companies established that are relatively new, and this has contributed to a buoyant SME sector that contributes nearly 50 percent of GDP and serves as a major employment generator. Consequently, Poland gets good ratings for small-scale privatization, but mediocre ratings for large-scale privatization.

A majority of Poland's top 100 companies are still owned by the state/Treasury, and only eight have been privatized in the last two years. Forty percent of the industrial work force remains employed by SOEs, although these numbers are beginning to decline. Where privatization is hard to achieve, such as for troubled coal mines, steel companies, non-ferrous metals producers, coke producers, and some machine tool manufacturers, restructuring plans have been put into place. This has been true in some of the major steel firms (even though privatization plans have been delayed or targets missed), and in the coal sector where mines have been closed, production cut and the work force reduced by about 25 percent[90]. The target has been to sell virtually all state enterprises by 2002 apart from the post office, railways, and troubled coal mines, although this schedule could be delayed with a change in government and unclear timing of entry into the European Union. Under any scenario, significant privatization is expected to be finalized in a range of industrial sectors as well as in banking, insurance, power generation, telecommunications and transport by 2002.

Meanwhile, Poland gets good ratings for its trade and foreign exchange system, having removed most quantitative and administrative restrictions that apply to international trade as far back as 1990, having introduced a fairly uniform customs regime and current account convertibility, and having virtually eliminated government interference in export-import flows from state trading monopolies (likewise in 1990).

The capital account was liberalized in 1999, as the new foreign exchange law eliminated restrictions on internal foreign exchange transactions between banks and non-banks. The current account was liberalized several years earlier, and portfolio flows have been fairly significant over the years. NBP reserves the right to intervene to protect safety and stability in the financial sector. Nevertheless, for all intents and purposes, the capital and current accounts have been

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[87] Most SOEs are in the industrial sector. This includes petrochemicals, electrical appliance manufacturers, and pharmaceuticals companies targeted for privatization by 2000, and power generation, mining and quarrying, sugar processing, pulp and paper, furniture, chemicals, plastics, building materials, and gas extraction and distribution companies slated for privatization by 2001.

[88] Poland started with more than 8,400 SOEs in the early 1990s. About 3,400 SOEs still existed in early 1998. By mid-2000, this number was down to about 3,000.

[89] In 1998, Poland only privatized 17 of 50 planned major transactions. Nevertheless, it exceeded targets for privatization receipts, generating $2.1 billion as opposed to the $1.9 billion target. See Transition Report: 1999, European Bank for Reconstruction and Development.

[90] See The First Polish Economic Guide: 2000.

liberalized. Movement towards a fully free-floating exchange regime indicates the market will set exchange rates.

Competition and pricing policy are generally harmonized with EU legislation. Most trade protection has been removed, although remaining barriers—mainly in agriculture—are still in place and are creating some negotiating friction with the EU. Nevertheless, it is expected that these will also disappear or diminish in the coming years for Poland to comply with a host of international agreements and obligations[91].

There has been growing FDI since 1996, totaling $18.9 billion from 1996-99. FDI has been invested in the automotive, food processing and power plant sectors, telecommunications, and banking and insurance. While Poland is competitive in a number of products—about 70 percent of its international trade is with EU markets—it has been challenged recently by the decline in eastern markets, competition from other regional producers, and net outflows on the services account. This has manifested itself in high current account deficits in recent years, reaching as high as 7.6 percent in 1999.

A major structural challenge in the coming years will be the outcome of new efficiencies and investments in the industrial sector, and to see if competitiveness in this sector serves as a catalyst for smaller firms to grow. A second challenge will be managing the balance of payments as higher levels of debt service come due in 2002-2006. For now, the outlook is positive due to high FDI inflows, and the likelihood of continued portfolio investment. However, competitiveness in the SME sector may also depend on reduced bureaucracy, higher labor productivity, and further development of equity markets. This will require higher levels of transparency and disclosure than many are currently used to. Moreover, banks and the bond markets will need to continue to develop for companies to obtain needed debt financing for long-term needs.

Banks have shown a willingness to lend in recent years, but this cannot be guaranteed as automatic for most firms. However, trends have been more auspicious in recent years, with banks and others increasing capital, expanding their investment in retail networks, and providing a broader array of services. Meanwhile, until recently (3Q1999), inflation rates and interest rates have come down, reducing the cost of credit to companies. While the funding base for banks is still relatively thin, more people have term deposits. This has increased the funding base for banks, and should also contribute to lower rates on loans over time. **Score: 3+**

2.1 General

Poland has several economic weaknesses, including a growing current account deficit, rising levels of debt, fiscal deficits, and stubborn inflation and unemployment rates. Nevertheless, Poland's economic indicators are broadly favorable at the macroeconomic level.

Growth has been high for several years, although real GDP growth was at lower rates in 1998-99 than in the previous four years. This slowdown was due to some sluggishness in Western Europe, troubles in Russia and neighboring states, and general skittishness of international investors in emerging markets in 1998-early 1999. However, after declines in 1990-91, Poland's real GDP is in its ninth consecutive year of real growth—powered mainly by the growing private sector and, more recently, strategic investment in major privatization transactions. From 1994-97, real growth rates averaged 6.25 percent. This declined to 4.8 and 4.1 percent, respectively, in

[91] Poland is a member of the OECD, WTO, EFTA and CEFTA.

1998-99.

Official unemployment has fluctuated over the years, peaking at 16.4 percent in 1993 and dropping to 10.3 percent at end 1997. However, unemployment is back up to more than 13 percent now, roughly comparable to 1992. All together, a net 885,000 jobs have been created since first quarter 1994[92].

Tight monetary policy has brought the inflation rate down steadily—from 70 percent on average in 1991 to an average 32 percent in 1994, 14 percent in 1997, and about 7.3 percent in 1999. The year-end 1999 CPI rate was 9.8 percent, higher than the 8.6 figure at end 1998. Inflation continued to rise in early 2000, and the current annual rate (as of mid-2000) is 11.6 percent. This raises the risk of higher interest rates, and with that, the potential for higher rates of default and portfolio performance weaknesses. Nevertheless, overall, Poland steadily brought down the inflation rate in the 1990s. With a 6.8 percent upper bound set as a target for year end by the Monetary Policy Council, it is expected that the inflation rate will begin to soon decline, although these prospects are partly offset by high sustained oil prices and potential risks to dramatic interest rate increases imposed by the MPC.

The government fiscal deficit has declined from a high 6.7 percent in 1991-92 to about 3-4 percent since 1993. These figures include local government and off-budget items that go to assist loss-making enterprises in coal, steel and other selected sectors[93]. Health and social insurance costs accounted for a sizable portion of the deficit. Budget subsidies to enterprises have declined in Poland in the 1990s as enterprises have been privatized, and as Poland has sought to get its fiscal house in order. Pension/social security costs remain high, but the new pension reform introduced in 1999 is expected to reduce this burden to the budget over time. In general, the fiscal picture has improved in recent years as the economy has grown, revenues have increased, and expenditure has been brought increasingly under control. Reduced rates on investments in government securities serve as an example of the easing of pressure on government finances.

Exchange rates depreciated against the dollar in late 1999 after appreciating in 1998. Poland has experienced a steady and significant increase in international trade—total merchandise exports and imports were about $74 billion in 1998, more than three times levels in 1991 and more than twice levels achieved through 1994. The current account deficit was $11.7 billion in 1999, equivalent to 7.6 percent of GDP. This represents a major increase from $4.5 billion in 1997, when the current account deficit was 3.1 percent. Meanwhile, gross international reserves declined for the first time since 1995, falling from $27.4 billion at end 1998 to $25.5 billion at end 1999, equivalent to about six months of import coverage of goods and non-factor services. This compares with about three months' coverage from 1991-94. Portfolio flows have grown steadily since 1994 with increasing liberalization and capital markets development, providing short-term financing. More importantly since 1998, FDI has grown significantly, accounting for more than $13 billion in inflows. This compares with an unimpressive $2.6 billion from 1989-1995. Thus, in these two years, annual average per capita FDI has increased from less than $10 from 1989-95 and $61 in 1996-97 to $167 in 1998-99. Expectations are that FDI will be sustained at comparable levels for the next two to three years, and then portfolio flows will become more prominent.

Score: 3+

- *Real GDP growth* was 4.1 percent in 1999, slightly lower than 4.8 percent in 1998 and an

92 Most job growth has been in services, both market-based as well as public administration. In these two categories, a net 1.1 million jobs have been created. Agriculture and forestry have been flat, construction has shown some increase, and mining and manufacturing have shown declines.

93 This is in the form of arrears, capitalized interest, and other forms of assistance.

average 6.25 percent in 1994-97. Growth was powered by domestic demand and continued increases in consumer spending. This has partly been financed by banks and other intermediaries, which have increased lending to households and small businesses. According to NBP, loans to "persons" accounted for 22 percent of total loans at end 1999, having grown 53 percent from 1998. On a GDP basis, consumer loan outstandings have grown from 3 percent in 1996 to 6 percent in 1999[94]. This demand-pull may have been one of the contributing factors to MPC raising interest rates by 450 basis points from November 1999 to February 2000. Such consumer spending is clearly contributing to the burgeoning current account deficit, although the latter is also being driven by capital investment as industry re-tools and services invest in advanced information systems. Initial projections for 2000 are that Poland will experience real GDP growth of about 5 percent as the West European economy begins to show signs of increasing strength, direct investment continues to grow in Poland, the fiscal deficit remains under control, and tax rates continue to come down. Moreover, the inflation rate is manageable compared with earlier years (notwithstanding monthly increases since August 1999), and there still appears to be a high level of confidence in growth prospects despite rising unemployment.

- The registered *unemployment* rate was 13.0 percent at end 1999 and 13.9 percent at March 2000. This represents a significant and dramatic increase from 9.6 percent in 2Q-3Q 1998 and 10.4 percent at end 1998. This equates with a net increase of nearly 700,000 unemployed from end 1998 and March 2000. Productive *employment* is a more difficult measure to gauge. However, if GDP figures are applied in dollar terms to employment levels, productivity increased in 1999 at about $9,900 after increasing from about $9,300 in 1997-98[95]. In terms of sector distribution, about a quarter of the work force is employed in agriculture and forestry, about 22.5 percent in industry and mining, and about half in services and construction. These figures are about the same as in 1997, when agriculture and industry accounted for half the work force.

- *Inflation rates* had steadily declined since 1991 until they reversed course and started to rise in August 1999. Back in 1991, the average CPI inflation rate approximated 70 percent. Rates dropped to 43 percent in 1992, 20 percent by 1996, and as low as 7 percent in 1999. However, the trend since August 1999 has been upward, and CPI measures were consistently above 10 percent in the first quarter of 2000. As of mid-2000, the annual rate was 11.6 percent. Initial targets for 2000 were to bring the year-end inflation rate down to less than 6.8 percent, which would be 3 percent less than the year-end 1999 figure. Given recent trends, this appears unlikely to occur. The producer price index (PPI) has generally declined throughout the 1990s, with average PPI as high as 41 percent in 1991, dropping to about 25 percent in 1994-95, and then being cut in half in 1996-97. By end 1998, average PPI was 7.3 percent, about 4.5 percent below average CPI. PPI at end 1999 was about 8.5 percent, considerably higher than end 1998 figures. Overall, the trend has generally been favorable throughout the decade. However, Poland's CPI rates are still fairly high by EU standards. This likely points to a tightening of monetary policy, particularly if the current account deficit continues to grow.

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[94] Cited from Wojtowicz, Grzegorz, "Constant Growth", *Bank*, March 2000.

[95] This is based on (i) estimated GDP of about $155 billion in 1999, $147 billion in 1998, and $143 billion in 1997; and (ii) paid employment of 15,658 thousand in 1999, 15,800 thousand in 1998, and 15,439 thousand in 1997.

• *Exchange rates* were previously set by NBP on a monthly crawling peg basis against a basket of currencies that reflected the mix of its foreign trade patterns[96]. Average exchange rates against the dollar have declined from PLN 3.28 in 1997 to PLN 3.49 in 1998 and PLN 3.97 in 1999. As of March 2000, the zloty was at 4.09 to the dollar and 3.95 to the Euro.
• *Fiscal deficits* have been kept at about 3-4 percent from 1993 on. Earlier fiscal problems resulted from high social welfare costs (social security), and weak revenues due to the avoidance of tax payments by many companies and households. On-budget subsidies to enterprises have been cut throughout the 1990s, from 5 percent of GDP in 1991 to less than 2.5 percent in 1998-99. These cuts contributed substantially to the reduction of fiscal deficits in the early 1990s. Stronger revenues are expected from a stronger economy, reduced tax rates, and improvements in tax administration. Privatization is also making a major contribution by adding proceeds and in helping to reduce off-budget expenditure. Privatization proceeds have increased from about 2 percent of GDP in 1994 to as high as 6.7 percent in 1998 and an estimated 3 percent in 1999. Administrative reform introduced in January 1999 should put increasing responsibility on localities to develop and maintain a viable fiscal base, although the budget process remains highly centralized. Even more importantly, pension reform should help reduce transfers from the budget over time, mainly for the social insurance and labor funds that have indexed pensions and benefits to wages[97]. According to the IMF, the consolidated fiscal deficit was 3.8 percent of GDP in 1999. The central government deficit was PLN 12.6 billion, or about 2.1 percent of GDP.
• *Debt and debt service* are under control. In one sense, there has been steady improvement in the level of public debt, which has declined steadily as a percent of GDP. Public debt was 43 percent in 1998, down from 49 percent in 1997. However, corporate debt has increased in recent years, and there are risks that mounting private debt in the corporate sector could create current account and, potentially, balance of payments problems in the coming years should there be a slowdown in the economy[98]. Total gross external debt has approximated $45 billion since end 1998, about 30 percent of GDP. This trend has been fairly consistent in dollar terms throughout the 1990s, diminishing as a percentage of GDP—from 47-62 percent in the early 1990s to about 30 percent since 1996. Meanwhile, gross foreign exchange reserves approximated $25.5 billion at end 1999, down nearly $2 billion from end 1998. Debt service as a percent of the current account peaked in 1991 at 69 percent. This has declined steadily since, and was less than 6 percent in 1997. Due to its strong foreign exchange reserves, Poland is not expected to have any problems servicing or repaying its obligations according to schedule. However, with a current account deficit of nearly 8 percent, the authorities are closely monitoring reserves and debt service requirements. This is of particular importance given that official foreign exchange reserves fell for the first time since 1995.

[96] The policy of NBP was to pursue a slow but steady devaluation of the zloty against a basket of currencies. In late 1999, the basket was composed of the U.S. dollar (45 percent) and the Euro (55 percent). This approach was changed in April 2000 to a fully free floating regime.

[97] This led to a nearly fourfold increase in social security costs in dollar terms from 1989-97. As a share of GDP, this cost doubled from 1989 to 1997. This prompted reform, which was introduced in 1999.

[98] See “The Polish Economy”, Bank Handlowy, April 2000.

Table 1: General Economic Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999(e)	2000(p)
Real GDP Growth (%)	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	6.8	4.8	4.1	5.4
Per Capita Incomes:											
GDP in $	1,547	2,037	2,197	2,234	2,399	3,084	3,486	3,512	3,887	3,954	4,152
PPP in $	4,570	4,490	4,750	5,010	5,380	5,400	6,000				
Registered Unemployment (%)	6.3	11.8	13.6	16.4	16.0	14.9	13.2	10.3	10.4	13.0	13.4
Inflation Rate—CPI (yr-on-yr)(%)	249.3	60.4	44.3	37.6	29.5	21.6	18.5	13.2	8.6	9.8	7.0-7.5
Yr-end. Exchange Rates											
PLN:ECU/Euro								3.93	4.10	4.22	
PLN:US$	0.95	1.10	1.58	2.13	2.44	2.47	2.88	3.53	3.49	4.17	
Fiscal Deficit/GDP (%)	-3.7	6.7	6.7	3.1	3.1	2.8	3.3	3.1	3.0	3.0	2.8
Debt Service/Current Account (%)	53.7	68.9	19.3	20.1	14.3	6.7	7.6	5.9			
Current Account Deficit/GDP (%)		2.6	-1.1	0.7	-2.5	-4.6	1.0	3.1	4.5	7.6	7.0-8.0
Public Debt/GDP (%)			147.3	108.6	69.0	59.0	53.6	49.4	43.0		
Gross Ext'l Debt ($ bn)	48.5	48.0	47.6	47.2	43.6	45.2	41.6	43.0	45.0		

Sources: NBP, EBRD, IMF, World Bank, OECD, CASE, Bank Handlowy, Citigroup, *Business Central Europe*, *Euromoney*, estimates.

2.2 Private Sector Development

Private sector shares of employment and GDP are reasonably high—estimated by EBRD at about two thirds[99]. Much of the strength of the Polish economy is derived from the dynamism of its small business sector. By the mid-1990s, Poland had nearly 2 million businesses that were individually owned, and about 100,000 private companies that were joint stock companies or joint ventures. However, Poland still has about 3,000 SOEs, and some of Poland's largest companies and exporters are majority or wholly state/Treasury-owned. Thus, while Poland is moving irrevocably to a private sector-dominated economy, there is still a strong presence of the state/Treasury in many key industrial and service sectors. More than half of Poland's 100 largest companies have state/Treasury ownership.

The private sector had already established its dominance in commercial trade—wholesale and retail—and construction, and was about even with the state sector in industrial output by 1996. Since then, investment trends have indicated a growing share from and into the private sector. Most recently, this has come from FDI.

In terms of employment, the private sector dominates in agriculture, manufacturing, construction, trade, and real estate and other business services. Paid employment figures point to about 70-75 percent of people employed in the private sector[100].

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[99] See Transition Report: 1999, EBRD.

[100] This assumes 95 percent in agriculture, 60 percent in manufacturing and mining, 90 percent in construction, 100 percent in market services, and zero percent in non-market services. Figures are from end 1999 from the Central Statistical Office. EBRD has estimated that as of 1998, about one third of employees were still employed by Government or SOEs. However, there was no explanation of the methodology used for this estimate.

Privatization plans of the current government are to have virtually all enterprises in private hands by 2002, with the exception of the railways, postal system and troubled coal mines. This could push private sector shares to 90 percent or more by 2002. Major privatizations in process include PZU (insurance), TPSA (telecommunications), the two largest oil refineries, and several power stations. One other major privatization in 2000 is expected to be for shares of KGHM (copper).

In the banking sector, it remains to be seen how and when BGZ and PKO BP will be privatized, although PKO BP is likely to float shares on the WSE with share distributions included for employees and pension funds. Over time, it can be expected that management would sell shares, and that strategic investors might eventually assume greater responsibility. However, these privatizations are not yet in motion[101].

In terms of financing for the enterprise sector, many new companies that have started up in the last five-seven years are often among the most credit worthy in terms of prospects. New or privatized companies have accounted for half or more of industrial output and transport, and 90 percent or more of construction and trade since 1997-98. Banks have provided more loans to them in recent years, particularly as competition for blue chip customers has been fierce and margins with SME customers are higher. Increased access to bank financing has been evident since late 1995, and lending to SMEs appears to have grown since 1997, although not as quickly as consumer lending. Poland's banks also appear more willing to lend to new firms than their regional peers in Hungary and the Czech Republic[102].

WSE has also opened additional trading floors since 1997, providing potential financing to about 100 or so SMEs on the parallel and free markets. What has not occurred is meaningful expansion of the over-the-counter market (CeTO), which added only nine companies to its market in the last two years. Over time, a larger number of firms will need to be able to access formal financing, be it from banks, markets or other financing vehicles.

BRE has recently acquired a Vienna-based factoring firm. There is clear interest in leasing. Venture capital is beginning to take hold in Poland. Meanwhile, institutional investors will play a growing role in the coming years as life insurance companies, pension funds, and mutual funds assert themselves as investors in the market.

Meanwhile, state companies still account for a major portion of the blue chip sector. Among Poland's largest 100 companies, 52 are wholly or majority state-owned, down a bit from 60 in 1996. Forty percent of the industrial work force continues to work for SOEs, and more than one third of service sector employment is in Government or for SOEs. However, in one to two years, ownership in several key industries and services will pass on to private ownership on the condition that the fiscal situation has improved, and GoP/Treasury does not hold on to hard to sell firms because of the need for high levels of privatization proceeds to shore up deep fiscal deficits.

Direct bank lending to the state-owned enterprise sector has diminished over the years, and budgetary subsidies have generally declined since the early-mid-1990s as a share of GDP. Meanwhile, Poland has moved ahead with privatization in the power sector, banking, insurance,

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101 The Treasury is currently in the process of hiring a privatization advisor for PKO BP.

102 See Bratkowski, Andrzej, Irena Grosfeld, and Jacek Rostowski, "Investment and Finance in *de novo* Private Firms: Empirical Results from the Czech Republic, Hungary and Poland," Center for Social and Economic Research, Warsaw, 1998."

103 Central and Eastern Europe and the Baltic States.

104 In fact, Poland has received more FDI each year than all other transition countries since 1996, apart from Russia in 1997. That year, Poland was second.

105 According to NBP data, exports were $26.3 billion. Central Statistical Office data (from Customs) showed exports at $27.4 billion.

airlines, petrochemicals, and telecommunications. Resistance to FDI has diminished significantly since 1996, and Poland attracted more than $13 billion in 1998-99. This made Poland the largest recipient by far among transition countries, accounting for 40 percent of all FDI among non-CIS countries[103]. Among all transition countries, Poland attracted 30 percent of total. Thus, Poland has clearly been the star performer among transition countries in attracting FDI since 1998[104]. Progress in finishing privatization, along with modernization of agriculture, will be core issues for Poland to meet economic criteria for entry into the EU. Meanwhile, at the "unregistered" end of the economic spectrum, the EU has applied pressure on Poland to contain open-air market trade due to border crossing requirements. Poland has complied, but this is one of the reasons why export trade with eastern countries has diminished. At end 1997, "unclassified current transactions" were valued at $6 billion, or about 22 percent of registered exports in 1997. By 1999, these transactions had declined to an estimated $3.6 billion, or about 13.5 percent of registered exports[105], and account for about two thirds of the decline in exports from 1998 to 1999. **Score: 3+/4-**
• *Sector share of GDP* in the Polish economy has shifted throughout the 1990s, as it has elsewhere among transition countries and around the globe. In light of the structural bias in favor of heavy industry and the neglect of consumer-based services during the communist era, the 1990s reversed these biases. Consequently, there has been steady movement towards services, while agriculture and industry have contributed less to overall GDP. <u>Services</u> accounted for about 48 percent of GDP in 1990 and 53 percent in 1991, comparatively high figures for ex-socialist economies at the time. Today, about two thirds of Poland's GDP is in services. In dollar terms, this amounts to an increase from about $28 billion in services output in 1990 to about $100 billion in 1999. Growth has come from a wide range of sectors—market research, advertising, software development, electronics, engineering, telecommunications, architecture, accounting, banking, insurance, other financial services, commercial trade, legal, medical, construction—much of it in response to the modernization needs of the Polish economy as it prepares for entry into the European Union. <u>Industry</u> accounts for another 25 percent or so of total GDP, down from about 45 percent in 1990. In dollar terms, industrial output has increased from about $26.5 billion in 1990 to about $40 billion in 1997-99. The scale of Polish industry has declined considerably during the reform period, and growth is now often found in some of the smaller manufacturing companies that have been established in the 1990s. Meanwhile, some heavy industry is still making a strong contribution to GDP growth, such as in the auto sector. However, steel and mining remain troubled sectors. Coal is expected to undergo a continuous downsizing effort over the next several years. Efforts to privatize major steel makers have been unsuccessful, partly due to excess capacity in international steel markets. Meanwhile, <u>agriculture</u> accounts for about 6 percent of GDP, although it employs about 25 percent of the work force. Agricultural output has increased from about $4 billion in 1990 to about $9-10 billion since 1997.
• *Corporate finances* deteriorated in 1999, reflecting a slowdown in the economy and competitive challenges facing many of Poland's larger industrial companies[106]. Based on GUS/NBP data, pre-tax profits declined by 23.6 percent in 1999 from 1998, and net profits were down 90.4 percent. Costs increased to 98.8 percent of sales, and pre-tax margins were

[106] See "The Polish Economy", Bank Handlowy, April 2000.

	down to 1.4 percent. Thus, net margins in the corporate sector appeared to be only about 1 percent on average. This represents the second straight year in which corporate financial figures were relatively weak[107]. The deterioration of these finances partly relate to foregone trade in eastern Europe (e.g., Russia) and slower than expected growth in Western Europe (until recently). However, more pointedly, the deterioration of corporate finances has also made more explicit the need for accelerated restructuring in the industrial sector for export competitiveness. This is currently being remedied, and explains some of the increase in unemployment rates in recent months as industrial enterprises invest in new plant/equipment while shedding unneeded labor.
•	As for *employment*, there were 15.2 million people actively employed as of March 2000, down by 600,000 since the end of 1999. Consequently, the unemployment rate increased from 13.0 percent at end 1999 to as high as 13.9 percent in March 2000. Compared with end 1998, these figures represent an increase in the unemployment rate by 2.6-3.5 percent over a 12-15-month period. At end 1999, there were 2.35 million registered job seekers. It is projected that there will be 1 million new entrants to Poland's work force between 2000-2005, partly driven by demographic pressures[108]. Today, about 47 percent of the work force is employed in services. If construction is added, this would bring figures up above 52 percent. Meanwhile, about a quarter each are employed in agriculture and industry.
•	The comparatively high level of *employment in agriculture* is traditional, largely based on private small-holdings that escaped nationalization and collectivization during the communist era. These farms are small—the average farm size is about 8 hectares, or 20 acres, and is focused on the production of potatoes, fruit, vegetables and meat. Farming is responsible for only 6 percent of GDP, reflecting low productivity. Agricultural employment shares are about four times the relative contribution to GDP from the primary sector, the inverse of prevailing trends in OECD and EU countries. This is partly due to farming being a part-time occupation for many people who are otherwise employed elsewhere, using their farms for subsistence of extra income rather than as a primary income source[109]. Nonetheless, there is sufficient opposition to reform in the farm sector that may complicate negotiations with the EU on entry. Modernization of equipment and agribusiness practices will be required for Poland to come to agreement with the EU on entry. For the time being, little progress is expected. The demographics of the sector suggest that fewer people will work in agriculture, and this may lead to some consolidation over time. Development of a modern land market that permits foreign participation will eventually be needed, but this is not going to be politically acceptable any time soon. Test cases with state farms would be useful, but there has been little momentum in this direction over the years. Not surprisingly, unemployment, alcohol abuse and other deep social problems are prevalent in many of the regions where state farms formerly served as major employers. The absence of modernization and reform has translated into foregone development. Meanwhile, as younger people who stay in farming adapt to modern challenges, this should prompt newer structures and investments in equipment. However, for the time being, progress towards reform in this sector will remain politically sensitive in

[107] In 1998, corporate costs/sales were 98.1 percent, and pre-tax margins were only 2.0 percent. Thus, the corporate sector did not generate strong profits in 1998.

[108] Poland's average age is 35, making the country's population comparatively young. Among the total population, 24 million people are urban and 15 million are rural.

[109] It is also not at all clear if the statistics used to measure output for comparative purposes are comparable.

Poland.
• *Industrial sector employment* has shown varied trends. Overall employment in mining and manufacturing has declined significantly since 1995. At end 1995, there were 3.78 million employed in these areas. By end 1999, total employment had declined to 3.48 million. This trend continued through 1Q 2000, with the total at 3.35 million. Thus, in the space of 17 quarters, employment in the industrial sector had declined by more than 11 percent. Polish manufacturing was showing signs of increasing competitiveness in the mid-1990s as smaller, more efficient firms increased their presence in the market. From 1992-94, industrial labor productivity increased an average 13 percent per year. However, the still large number of SOEs in the mining and manufacturing sectors has contributed to lower figures since. Mining and steel are two areas that are particularly problematic. While both sectors are undergoing restructuring to reduce excess staff and inefficient energy consumption patterns, they still bring down some of the labor productivity statistics.
• Private sector penetration in the economy is high, estimated to be about two thirds of the economy in GDP and as much as 75 percent of employment. Overall p*rivate sector contribution to GDP* has been estimated to be about 65 percent since 1997. Private sector growth initially resulted from a reduction of budgetary subsidies to loss-making state enterprises—either directly from fiscal sources, or through banks—although off-budget financing continued[110]. More recently, high levels of FDI have provided significant resources for private sector development. Some of this has been incremental to earlier investment, and some has been spurred on by privatization[111]. There have also been steady increases in credit to the private sector since late 1995, with Pekao SA and Kredyt Bank serving as the leading lenders to the SME sector. About 40 percent of bank lending is currently to firms with less than 250 employees[112]. *Employment in the private sector* was estimated to be about 10 million by end 1997, or about two thirds of those employed. Other estimates point to higher employment in the private sector approximating 75 percent of total. The private sector is also widely credited as being responsible for most new job creation and increases in labor productivity.
• State sector value-added and employment represent a slowly but steadily declining segment of the economy. There are still more than 3,000 SOEs, down from 8,441 in 1990. The *state share of overall GDP* has declined from 69 percent in 1990 to about one third since 1997. This actually translates into an increase in overall state contribution to GDP—from $41 billion in 1990 to about $50 billion since 1997. However, the state's share of total GDP has declined by about half. Increased output from state enterprises is primarily in the services, and where prospects for privatization are brightest. These have included telecommunications, transport and some industries. As many of the SOEs have themselves undergone restructuring programs, some of them are more efficient or less uncompetitive than in prior years. Meanwhile, *employment in the state sector* was estimated at about 4 million at end 1999,

110 More recently, state assistance to troubled sectors has been made more explicit in the budget for reasons of transparency.

111 While privatization has never been a fast process in Poland, it has continued throughout the years. When the Law on Privatization was passed in 1990, there were 8,441 enterprises to be transformed. About 3,400 remained in state hands in early 1998, and about 3,000 remain today.

112 See *Business Central Europe*, April 2000.

down from an estimated 8.25 million in 1990. Thus, there has been a fairly steady decline in public sector head count, representing a cutback of about half over the decade. Many of the remaining jobs are in public administration, education, health, social security, and other community, social and personal service activities. "Non-market" services accounted for 2.4 million employees, about 60 percent of total non-private employment.

Table 2: Private Sector Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999(e)
GDP ($ billions)	59.0	76.4	84.3	85.9	92.6	118.0	134.9	143.0	147.0	155.0
o/w Agriculture (%)	7.4	6.8	6.7	6.6	6.2	6.6	8.1	8.2	8.8	9.3
o/w Industry (%)	44.9	40.2	34.0	32.9	32.2	28.9	36.6	40.2	41.3	
o/w Services (%)	47.7	53.0	59.3	60.5	61.6	64.5	90.2	94.6	96.9	
Private Sector GDP ($ billions)	18.2	32.2	39.7	44.6	48.3	70.0	85.7	93.0	95.6	100.8
State Sector GDP ($ billions)	40.8	44.2	44.6	41.3	44.3	48.0	49.2	50.0	51.4	54.2
Employment* ('000)	16,145	15,443	15,010	14,761	14,475	14,735	15,021	15,439	15,800	15,658
o/w Private Sector ('000)	7,895	7,752	8,060	8,384	9,851	10,084	10,594	10,962	11,642	11,539
o/w PS in Agriculture('000)					3,692	3,644	3,809	3,786	3,770	3,734
o/w PS in Industry ('000)					1,483	1,630	1,865	1,870	2,209	2,106
o/w PS in Services ('000)					4,676	4,810	4,920	5,306	5,663	5,699

* Employment figures all based on averages from 1994
Sources: EBRD, World Bank, CASE, estimates

2.3 Money, Savings and Credit

The NBP has pursued a tight monetary policy since the hyperinflationary period in 1989-90. Beginning in 2000, the focus of monetary policy appears to be strictly on price stabilization, with explicit goals of declining inflation rates and the achievement of inflation targets. The move to a fully free-floating exchange rate regime appears to signal a shift in monetary policy following five years in which monetary policy followed a crawling peg. The current approach is intended to increase the sensitivity of firms to price changes in international markets to increase their competitiveness. This is viewed as a necessary step prior to entry into the European Monetary Union (EMU), slated to occur some time in the coming decade.

Prior to the current approach, monetary policy focused on gradual devaluation of the exchange rate, a steady decline in the inflation rate as reflected in slowly declining interest rates, and generally tight monetary policy to prevent an "overheating" of the economy. The last point has been in evidence over the years, including recently, when the MPC raised interest rates 450 basis points in total on two separate occasions between November 1999 and February 2000. (It remains to be seen if additional interest rate increases will occur, particularly as the inflation rate remains above target.) Thus, the inflation focus has been a central theme, even during earlier periods of high unemployment. In that sense, movement to a free floating exchange rate and an inflation-targeting approach to monetary policy is not a radical departure from past practices. What is unclear at the moment is if this change signals that the MPC will not engage in costly defenses of the exchange rate in the event of an attack. Under such circumstances, intervention would only be expected if there were a larger threat to overall macroeconomic and financial sector stability.

The effects of the earlier crawling peg regime and current floating exchange rate policy have shown benefits since 1995-96. Savings and credit have both increased since 1995. Households are now placing more funds in the banks on a term basis. For example, term deposits now account for 72 percent of total deposits held with banks, as compared with 70 percent in 1998. However, the total value of deposits at end 1999 was only PLN 5,356 per capita, little more than $1,300. Thus, the deposit base remains fairly low in Poland, even if the trend is favorable. Meanwhile, the cost of funds still remains fairly high for banks due to high real interest rates, still inadequate funding from deposits, the concentration of deposits in three banks[113], and the limited debt market for banks. There has also been some periodic volatility in the interbank market since 1997, most recently from about November 1999-March 2000, the period that coincided with rate hikes. This suggests that many banks remain sensitive to both the supply and pricing of funding due to the limited depth and breadth of the interbank market.

For the time being, the challenge to NBP appears to be achieving its inflation targets without causing a major contraction of the economy, withstanding possible attacks on the currency without dedicating hard currency reserves in defense, and reducing the excess liquidity of the banks during a period of declining inflation rates. While CPI measures have increased since August 1999, there is an expectation that the MPC intends to achieve its end year target of 5.4-6.8 percent. However, with annual inflation measures at 11.6 percent as of mid-2000 and a growing current account deficit, this may be difficult to achieve. Some market participants do not believe the target will be met, and that 7.0-7.5 percent CPI figures are more likely for December 2000[114]. If the target is not met, it will be important to see how the market reacts, and if more restrictive policy will be introduced at a later date. **Score: 3+**

- *Policy, design and implementation* are the responsibility of the Monetary Policy Council (MPC) of the NBP. The MPC is composed of the NBP President and nine other people representing three appointments each by the President of Poland, the Sejm (lower chamber of Parliament) and the Senate (upper chamber of Parliament). The Council was established on February 17, 1998 with adoption of the new Polish constitution. In September 1998, MPC issued its medium-term strategy for 1999-2003[115]. Major goals include reducing the inflation rate in the short term, achieving price stabilization over the medium term, and supporting the institutional development of modern financial markets. Based on these goals and objectives, guidelines for monetary policy are then established for each year based on a range of factors focused mainly on fiscal policy and exchange rate movements, and how these pertain to the achievement of MPC goals. The adopted strategy of MPC is that of direct inflation targeting based on CPI measures within reasonable tolerance bands. For the year 2000, MPC is most concerned about fiscal and current account deficits. Performance to date suggests that the

[113] PKO BP, Pekao SA and BGZ that, together, accounted for about 50 percent of deposits held with banks at end 1999. PKO BP alone was reported to hold 40 percent of savings accounts, equivalent to about PLN 60 billion.

[114] As an example, see "Economic and Financial Outlook," Citibank (Poland) S.A., June 2000.

[115] See "Medium-Term Strategy of Monetary Policy: 1999-2003", Monetary Policy Council, Warsaw, September 1998.

	fiscal house is under reasonable control, but that the current account is worrisome. The latter could also exacerbate the former if a tightening of monetary policy then leads to a slowdown in the economy, reduced fiscal collections, and a rise in unemployment claims. Other issues of concern include commodity price levels for food and raw materials, and increases in indirect taxes (e.g., VAT, excise, customs) that may reflect fiscal laxity. It is the stated goal of MPC to bring down the inflation rate to below 4 percent by 2003. The target for 2000 is 5.4-6.8 percent, reflecting a fairly wide tolerance band[116]. This represents a slight slowdown from targets set in earlier years. For instance, in 1998, the NBP target was to reduce the inflation rate to 5 percent by 2000 from the year-end 1997 figure of 13 percent. Nevertheless, on the positive side, the inflation rate has generally declined over the years, notwithstanding recent increases in CPI measures since August 1999. In 1999, the inflation target was set at 8.0-8.5 percent, and turned out to be 9.8 percent at year end. Moving forward, MPC expects GDP growth of 5 percent in 2000, and a current account deficit equivalent to 7 percent of GDP. However, first quarter results showed a widening current account deficit of 8 percent, implying that MPC might tighten policy to compress domestic demand. Given that most forecasters are predicting at least 5 percent real GDP growth in 2000, MPC may well feel there is room to tighten. Depending on actual conditions, the increase in money supply is projected to be PLN 38.8-47.9 billion, or 15-18 percent above end 1999 figures.
•	The *management and implementation of monetary policy* by NBP is based on two key goals: to support efforts to achieve annual inflationary targets, and to achieve price stabilization in support of long-term economic growth and financial market development. MPC is responsible for drawing up annual monetary policy guidelines, establishing basic principles associated with those guidelines, and reporting on performance to the Sejm within five months of the end of the fiscal year. MPC is also responsible for setting the limits on liabilities arising from loans/advances drawn by the NBP from foreign financial institutions. Five key instruments are used to implement monetary policy—interest rates, open market operations, reserve requirements, refinancing of commercial banks, and exchange rate intervention[117]. Thus, MPC effectively sets official base interest rates, determines the principles that apply to open market operations, determines the procedures for reserve requirements, and sets required reserve ratios for the banks. MPC is currently focused on commercial bank liquidity as the basis for determining which instruments to use in the implementation of monetary policy. For the near term, interest rate policy is expected to be maintained as NBP perceives the banks to have excess liquidity (see below). Thus, the Lombard[118] and rediscount rates will remain the key interest rates used by the central bank as monetary policy instruments. Open market operations will be utilized by NBP to mop up excess liquidity by issuing 28-day money market bills and to directly influence one-month rates in the interbank market[119]. Long-term

[116] MPC believes an increasingly wider tolerance band can be established in the coming years to better mitigate the impact of potential shocks. However, too wide a bank is recognized by MPC as lacking credibility. The increase in the tolerance band from 0.5 to 1.4 within one year raises questions about how this will be perceived in the business community.

[117] While Poland introduced a free-floating exchange rate regime in April, 2000, MPC still does not exclude the possibility of intervening in the market as a result of underdevelopment of the foreign exchange market.

[118] The Lombard rate sets the ceiling of inter-bank market interest rates, thus reflecting adjustments in monetary policy.

[119] MPC shifted the focus of monetary policy instruments from the monetary base to the use of interest rates as a means of controlling the money supply. This was executed by shortening the maturities of open market money bill instruments from 270 days to 28 days. The 28-day open market rate then became the reference rate.

interest rates are expected to be set by the market. NBP also has plans to issue bonds if necessary to meet policy objectives. In 1999, reserve requirements were lowered to 5 percent for all types of liabilities, down from 20 percent on zloty demand deposits and 11 percent on zloty time deposits in 1998. This was partly due to MPC efforts to reduce the degree to which banks were bypassing reserve requirements to reduce their costs[120]. NBP issued long-term bonds, which were purchased by banks with funds made available to the banks from the decline in reserve requirements. This represented a change in the pattern of rising reserve requirements, which began in late 1996 and persisted until early 1999[121].
• Until early 2000, NBP utilized a floating exchange rate that NBP managed through its interest rate policy, and by intervention through open market operations. While interest rates remain the primary monetary policy instrument and the zloty remains floating, there are *several changes that have recently been introduced*. First and foremost is the abandonment of the crawling basket peg in favor of a freely convertible exchange rate. This occurred on April 11, 2000. Second, and related to the first, is that NBP began to undertake a program in which it is to become a net lender to the banking system over time, rather than a net borrower from the banking system. In general, these movements point to the implementation of monetary policy based increasingly on open market operations, with liquidity and risk management by market participants based on institution-specific requirements that will be subject to prudential regulatory requirements in support of a stable monetary and banking system.
• *Data collection and forecasting* appear adequate. As found in earlier years, Poland's monetary forecasts have been reasonably accurate and sustained by a fairly consistent policy for several years. Even with changes in the exchange rate regime, Poland's NBP has consistently focused on bringing down the inflation rate. Where there is a level of uncertainty is with portfolio flows. Concerns regarding Asia, the ruble, and general fallout in emerging markets from late 1997-early 1999 were handled reasonably well by Poland. However, Poland remains a comparatively small market, and will thus remain vulnerable to rapid shifts in portfolio flows until markets have broadened and deepened to provide needed cushion. Poland is still engaged in this process, but it will take time before Poland has adequate economic and capital markets capacity to reduce its current level of vulnerability. In Poland's favor, its vulnerability appears to be anchored more in the level of growth in EU countries rather than in prevailing trends elsewhere around the globe. Moreover, high levels of FDI in recent years have reduced the sensitivity to rapid outflows.
• Poland has taken *regional and global considerations* into account since efforts began in the early 1990s to be positioned for membership in the WTO, OECD, EU, and other international and multilateral groups. The signing of the EU Association Agreement (1995), and membership in the WTO (1995) and OECD (1996) provided an economic catalyst for Poland to pursue economic reforms. Since then, Poland has worked closely with a range of institutions to facilitate entry into Western and global organizations. Poland removed most trade barriers as early as 1990, ultimately paving the way for entry into the WTO and OECD. While protectionist barriers were evident through the mid-1990s, direct investment has

[120] See Rybinski, K., and T. Linne, "The Emerging Financial System of Poland: Institutional Constraints and External Links," Center for Social and Economic Research, Warsaw, 1999.

[121] Ninety percent of required reserves were deposited in zloty with NBP, and 10 percent remained in the banks as vault cash. Reserves were not and still are not interest-earning.

	increased since 1996, partly reflecting a more open environment in which foreign investment was subject to fewer barriers. This has been evident in significantly greater direct investment from abroad—Poland's $13.1 billion in FDI in 1998-99 was 40 percent of total FDI to all non-CIS transition countries, and 30 percent of total FDI in all transition countries. In the area of financial sector development, Poland's regional and global considerations have been manifested through close collaboration with the Bank for International Settlements and the Joint Forum on Financial Stability to implement international standards and best practices in banking and financial markets, with the OECD in liberalized current and capital accounts, and the EU to ensure cross-border cooperation and coordination.
•	One of the key driving forces in the Polish economic and governmental landscape is *joining the European Union and the European Monetary Union*. In terms of monetary policy, the medium-term monetary strategy of the MPC explicitly notes that 1999-2003 coincides with Poland's preparations to accede to the European Union and, subsequently, to the European Monetary Union (EMU). In fact, integration of the Polish economy with that of the EU and EMU is viewed as a strategic goal. However, it is more likely that Poland will become an EU member after the medium-term strategy is implemented[122]. Recent trends indicate that there has either been a slowdown in movement towards satisfying the EU that Poland will be able to assume the obligations of membership by end 2002, or overcoming macroeconomic and structural hurdles has been more difficult than earlier anticipated. Over time, achieving or exceeding Maastricht performance criteria will be important for membership. Poland's figures are partly in balance with EU/EMU requirements, namely in keeping public debt below 60 percent of GDP. Nevertheless, Poland's inflation rate still exceeds the generally low EU standard of 2-3 percent and will not be below 4 percent until at least 2003. In fact, Poland's high real interest rates have served as a magnet for short-term portfolio money since early 2000, increasing interest rate and exchange rate risk to bank portfolios. With a free floating currency, the zloty will have to eventually be a part of the European Exchange Rate Mechanism for at least two years, and long-term interest rates will have to be within two percentage points of the EMU reference rate. Fiscal deficits of 3-4 percent are higher than the Maastricht criteria. Given MPC criticism of GoP fiscal policy, it can be expected that NBP will continue to exercise its independence and follow a tight monetary policy. Meanwhile, debt management will have to maintain satisfactory ratios (although public debt to GDP has grown in recent years), and there will be continued pressure on Poland's government to bring the consolidated fiscal deficit to below 3 percent of GDP. According to MPC and broad macro data, trends related to Maastricht criteria have generally not been favorable except in terms of movement of the inflation rate downward. Even here, events over the last year (since August 1999) have likewise not been favorable. The ability to meet EU economic criteria will depend on many factors, including the effectiveness and efficiency of structural reforms, administrative reform, pension reform, privatization of the last three major state banks and insurance companies[123], continued large-scale privatization in the real sector, and reduced subsidies to industries unlikely to be privatized before 2002. These challenges existed in 1998, and the general data indicate that Poland has made progress in

[122] Poland is not expected to join the EU until after January 1, 2003, although there has been no official notice from Brussels.

[123] The privatization of PZU is proceeding in a manner that should be found satisfactory to the EU. Even with share flotation through the Exchange, Eureko is able to accumulate a controlling stake in PZU. PKO BP is at the beginning of the privatization process, although shares will not likely be offered until 2001.

some of these areas. However, the macro indicators suggest that many of the remaining structural problems are fairly stubborn.

- It is the position of MPC that there is excess *liquidity* in the banking system. MPC has noted that NBP has been a permanent net borrower from the banks for short- and long-term financing since 1995 due to growth in the central bank's gross official reserves. Movement to a freely convertible exchange rate and greater reliance on open market operations is expected to reduce growth in official reserves and create a more transparent balance between liquidity and pricing in the banking market. NBP has proposed to GoP that public sector liabilities to the central bank be restructured and securitized. NBP believes this would encourage more effective implementation of monetary policy, with more direct signals sent by short-term market operations.

- *Deposits and funding* have been increasing since 1992. However, Poland still has relatively low levels of financial intermediation, as measured by broad money to GDP. These rates have moved up slowly, from about 32 percent in 1990-91 to about 43 percent in 1999. The influx of portfolio investment in recent years has driven up broad money measures, and represents one of the key challenges NBP faces in maintaining interest rate stability. The banking system's funding position has improved in recent years, as more of the public has opened up bank accounts and deposits have increased. However, for a country with nearly 40 million people, the amounts are still relatively small. Total deposits were valued at PLN 210 billion (about $53 billion) at end 1999, or about $1,300 per capita. Nonetheless, there was real growth of 10 percent in demand deposits and 7 percent in time deposits in 1999. Households account for about 70 percent of total deposits[124]. Household savings have been about 13 percent of GDP since 1995. These trends have been encouraged by positive real interest rates paid over the last several years[125]. Nonetheless, the interbank market remains thin. There is virtually no corporate bond market for banks. This has resulted in an increase in syndicated borrowings from banks abroad over the years, and by corporate customers as well. Funding in zloty is frequently subject to the availability of funds provided by PKO BP or Pekao SA, given their hold on 45-50 percent of banking system deposits. About 17 percent of balance sheet exposure was to the interbank market at end 1999, compared to 13 percent at end 1997. Interbank rates closely correlate with trends in the NBP rediscount and lombard rates. Reserve requirements were lowered to 5 percent on all deposits in 1999. However, some of the funds freed up were used to purchase NBP securities[126], while the balance was provided for incremental lending. Ironically, this may have had a short-term inflationary impact by pumping up consumer demand and serving as a catalyst for rising prices in the service sector.

- *Credit* began to increase at the end of 1995 as the major commercial banks had strengthened their capital positions (and therefore their lending capacity), and as net spreads on investments in government securities began to decline. Over the last four years, as competition intensified in the corporate sector and interest rates (and margins) declined, a great deal of new lending has shifted to the consumer sector to take advantage of greater turnover and higher margins.

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[124] See "Summary Evaluation of the Financial Situation of Polish Banks, 1999," National Bank of Poland, April 2000.

[125] See L. Orlowski. "The Development of Financial Markets in Poland," CASE, 1999.

[126] The effect of the "transaction" was to provide interest earnings on what are investments that serve as quasi-reserves, as opposed to having higher reserve requirements without any earnings.

In terms of overall credit, net domestic credit as a percent of GDP has diminished from a high of 40.7 percent in 1993, declining to 34.6 percent in 1995 before rising to the 35 percent range in 1996-97 and about 37.5 percent in 1998-99. Thus, credit has recently increased, including as a proportion of GDP. Key trends are a steady increase in credit to the private sector—from only 3.1 percent of GDP in 1990 and 11-13 percent from 1991-95, about 17 percent in 1996-97, and more than 20 percent in 1998-99. Meanwhile, net domestic credit to government has declined from more than 19 percent in 1993-94 to 10.5 percent in 1999. Net credit to the state enterprise sector has declined from 18 percent in 1990 to less than 5 percent in 1999. In dollar figures, net domestic credit has grown from less than $34 billion in 1994 to $61 billion in 1999. Most lending remains short-term. Lending is almost entirely collateralized.

- *Year-end base rates* have generally stabilized at about 10 percent above year end CPI since 1997. In general, nominal rates have come down considerably since 1997, as has inflation (until recently). Most nominal rates were down 5.5-7.7 percent by end 1999. However, year end 1999 rates were higher than those one year earlier, and early 2000 showed rates climbing up again. Year end 1999 rates showed the rediscount rate for bills of exchange at 19.0 percent, up from 15.5 percent January-October 1999. The lombard rate for three- to twelve-month funds was at 20.5 percent at end 1999, up from 17.0 percent January-October 1999. Three-month interbank rates ended 1999 at 18.0 percent, more than 3 percent above end 1998 three-month WIBOR (which was 15.9 percent in December 1998). Spreads tightened in 1998, but have increased since late 1999-early 2000 with the 450 basis point increase in interest rates. One source claims that commercial bank interest rates on loans has increased more than 100 basis points net of rates paid on deposits since interest rates began rising in late 1999[127]. Interest rates on deposits and loans were freed of administrative restrictions years ago, so pricing in credit has been liberalized for years. With increasing competition, particularly for "blue chip" business, net margins have continued to come down, a trend that was already in evidence in 1997.

Table 3: Money, Savings and Credit Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Money Supply Growth (%)		34.9	59.9	36.0	38.2	34.9	29.4	29.1	25.0	
Broad Money/GDP (%)	32.2	31.6	35.8	35.9	36.7	36.5	37.5	39.6	42.0	43.1
Year-end Base Interest Rate (%)*		36.0	32.0	29.0	28.0	25.0	22.0	24.5	18.3	19.0
Commercial Bank Rates (PLN)										
Interbank < 30 days (%)**		36.7	30.8	25.2	21.1	24.7	21.2	24.8	16.0	16.5
3-month T-bill (%)***			41.4	33.7	27.0	24.2	18.8	23.5	12.8	18.0
One-yr. time deposit (%)****	53.0	36.0	32.0	25.0	26.0	22.0	18.3	19.5		
One-yr. loan (%)****	61.0	40.0	39.0	35.0	31.0	24.0	23.3	25.8		
Net Domestic Credit/GDP (%)	19.5	34.9	38.2	40.7	39.2	34.6	35.3	34.9	36.4	39.3
o/w Claims on Gov't	-1.6	10.9	16.5	19.3	19.2	14.6	12.9	11.8	11.2	10.5
o/w Claims on SOEs	18.0	13.1	10.3	9.2	8.0	7.3	6.5	5.0	4.6	
o/w Claims on Private Sector	3.1	10.9	11.4	12.2	12.0	12.7	15.9	18.1	20.6	

Notes: * 1997-99 are year end rediscount rates; **1999 is 28-day repo rate at end year; ***1999 is 3-month WIBOR at year end; ****Rates on deposits and loans are for maturities up to one year at end 1997
Sources: NBP, EBRD, IMF, World Bank, CASE

127 See "Polish Economic Outlook: Quarterly 2/2000", CASE.

2.4 Fiscal

Fiscal policy was a cause for concern for the MPC, with considerable concern expressed over prospects for fiscal laxity in 1999. However, particularly on the strength of privatization proceeds, foreign direct investment, improved collections resulting from better administration, and the possibility of growing compliance as tax rates come down, total government deficits in 1998-99 have stayed in the 3-4 percent range. Considering that Poland has introduced significant administrative, health and pension reform over the last 18 months, fiscal deficits could have been more problematic.

One of the main concerns today is the current account deficit and high levels of domestic demand. Should the MPC need to further tighten monetary policy to achieve inflation targets, this could further drive up the mounting unemployment rate. This, in turn, would exacerbate the fiscal situation as collections might decline while benefits claims would increase. Social insurance costs will remain high for the foreseeable future, notwithstanding the important changes introduced in 1999. Meanwhile, despite hard budget constraints imposed over the years on most loss-making enterprises, there is still continued subsidization of some loss-making companies. These subsidies have amounted to about 2-3 percent of GDP per year since 1995. In dollar terms, this would approximate $15 billion since 1995.

Revenues have increased as the economy has expanded, but expenditure has likewise increased. The consolidated deficit was estimated to be 3.8 percent of 1999 GDP. About one-sixth is due to the high social security costs covered by government expenditure, some of which is expected to be less of a burden over time as pension reform translates into lower fiscal costs. However, these payments were only about 8 percent of GDP in 1989, representing an approximate increase from $6.6 billion in 1989 to about $25 billion in 1999. Thus, the implementation of pension reform is one of the most critical items on the Polish fiscal agenda.

Support for loss-making SOEs has diminished over the years, as direct budget subsidies have declined through the 1990s, from 5 percent in 1991 to less than 2.5 percent since 1997[128]. Moreover, banks have steadily reduced their credit exposure to the SOE sector, from 18 percent of GDP in the early 1990s to less than 5 percent of GDP today. Thus, banks have generally provided financing to SOEs on commercial terms and conditions in recent years, and their budget has been more transparent in identifying support for loss-makers (e.g., coal mines) when budgetary support has been provided. Poland's fiscal situation is greatly enhanced by privatization proceeds, and general inflows of foreign investment.

In 2000, privatization proceeds are expected to exceed PLN 20 billion as a result of the privatization of TPSA, KGHM, PZU, crude oil refineries, and other enterprises. Poland also benefits from EU funding, which should help finance some of the local government deficits projected for 2000. **Score: 3**

- Since 1998, *fiscal policy, design and implementation* have been focused on structural changes to the budget, namely changes in local government, pension reform, health reform, and a general reduction of the consolidated fiscal deficit to EU levels of 3 percent. Fiscal policy in Poland is undergoing a change as a result of the administrative reforms that were introduced in 1999. The gradual movement towards consolidation of voivods into larger administrative units and subsequent decentralization of some tax administration from the

[128] See Transition Report: 1999, EBRD.

center to these administrative units introduced major changes in how fiscal policy is conducted. It will take time for the administrative units to develop the capacity and the architecture for viable and sustainable financing. Larger cities are projecting deficits of about PLN 1.3 billion in 2000[129]. While some municipalities and administrative regions are well on their way, with a broadening fiscal base and high levels of economic growth, other areas are depressed and lacking in meaningful prospects. Moving forward, GoP fiscal policy will likely focus on ongoing administrative reform, social security, and social infrastructure (e.g., health, education) while leaving more local concerns to local authorities and larger infrastructure projects to European donor institutions (e.g., EIB, EBRD) and the capital markets. For the moment, MPC appears to be less concerned about potential problems of excessively loose fiscal policy. In 1999, the MPC expressed concern about the high level of the central government deficits, imbalances of municipal budgets, imbalances of the Social Insurance Fund and other target funds, and the continued growth of public sector liabilities and other state obligations related to pension reform, severance pay, retirement pay and general restructuring. MPC also criticized increases in VAT, and for not moving faster to reduce the role of wage/salary indexation. However, since then, privatization proceeds and foreign investment have helped alleviate some of the fiscal balance concerns, ZUS has shored up its financial position, and central government expenditure has generally been brought under control. Notwithstanding and the recent shake-up of the parliamentary coalition and election year risks, these changes have not prompted a severe tightening of monetary policy to counter potential concerns about a shift in fiscal policy. There are still concerns about pension and health care costs, particularly in the latter if privatization does not proceed. Rising unemployment and associated claims are also causes for concern. Elections in 2000 and 2001 raise the risk of some fiscal loosening. However, more recently, collections from corporate taxes and indirect taxes have improved. Along with optimism on the foreign investment front and favorable indicators in the EU and Western Europe (with which Poland conducts about 70 percent of its international trade), there is cause for optimism that Poland will be able to achieve its 3-4 percent consolidated deficit target, and bring it down further in subsequent years.

- *Data collection* and accuracy of *forecasting* are considered adequate in the development and management of fiscal policy. The stock of tax arrears—including social security payments—has diminished since the mid-1990s, and collections are generally improving as well. Lower corporate taxes are intended to reduce the flow of funds out of Poland (for reinvestment), and to increase the level of compliance to make further tax cuts possible in the future. As an example, Poland has been gradually lowering its corporate tax rates (from 40 to 30 percent) from 1997-2000, and collections from corporate taxes have recently increased faster than the rate of overall tax revenues[130]. Meanwhile, VAT and other indirect tax increases may help with overall revenue collection, and may serve as a catalyst to increase savings versus the high level of consumption that is currently fueling the economy and the current account deficit (as well as the recent MPC response in the form of higher interest rates). Where there may be a divide is with some of the balance of payments information in terms of levels of trade, how these are recorded (e.g., NBP vs. customs), and how these will potentially impact revenue flows. However, this is an open debate in the financial press among economists and others, and the fiscal authorities are clearly aware of these

129 See “Polish Economic Outlook: Quarterly 2/2000”, CASE.
130 See “Polish Economic Outlook: Quarterly 2/2000”, CASE.

discrepancies.
• *Regional and global considerations* are central to the development and implementation of fiscal policy and planning. Moreover, regional considerations have probably had a disciplining effect on fiscal policy, as the overall incentive to join the EU in the next several years has provided a framework for reform that might not otherwise have been pursued. Polish officials are aware of the 3 percent fiscal deficit target that is one of the four key Maastricht criteria for joining the European Monetary Union. Poland is attempting to reduce the central government fiscal deficit to as low as 1.5 percent of GDP in 2001[131] after hovering in the 2.1-2.4 percent range in 1998-99. The consolidated deficit has been in the general range of 3-4 percent for several years. As the economy continues to grow, administrative reform progresses, pension reform gradually helps to reduce the overall level of transfers in the budget, and privatization proceeds and FDI continue to increase, Poland should be able to maintain a fairly stable level of fiscal deficit financing. Over time, the goal will be to bring this level down, particularly as large-scale privatization runs its course over the next few years. Poland will also want to avoid characteristics of a domestic debt trap, where fiscal financing needs crowd out private investment. While Poland's debt management has been prudent to date, Poland is now more dependent on foreign financing than a few years ago. This has partly translated into high levels of growth, and has helped to make the economy more competitive. However, in the future, a series of factors could lead to a scenario where a slower economy could coincide with a period of higher fiscal deficits, a slowdown in foreign investment, a reduction in international trade, and high debt service requirements. While this scenario is not currently likely, particularly with growth picking up with its major trading partners in the Euro zone, it is a scenario that Poland will need to monitor from a risk management standpoint. The key fiscal issue will be avoiding a major convergence of negative fundamentals (i.e., reduced tax revenues, few remaining privatization proceeds, rising claims and expenditures) at a time of negative balance of payment fundamentals (i.e., lower foreign investment, rising debt service), particularly if the inflation rate has not come down to acceptable levels.
• Budgetary processes and procedures are still generally *centralized*, although there has been movement towards *decentralization* with the introduction of administrative reform in January 1999. The government transformed the administrative structure of Poland from 49 voivodships to 16 regions and about 320 self-governing boroughs. Over time, this will provide some devolution of tax and expenditure powers from Warsaw to the local level. Meanwhile, there is some movement towards municipal bond markets. As of May 2000, there were 66 municipal bonds that were out in the market, having been issued over the last three-four years. Most are for maturities up to five years, with a few exceptions. Total face value was PLN 624 million (about $160 million), or about PLN 9-10 million per issue[132]. This may pick up in the coming years in some of the more affluent municipalities. Growth in this area will help with the ability of localities to assume financing responsibilities for water supply, sewage systems, roads, public transport, and other local infrastructure needs and services as part of the overall administrative reform effort initiated in 1999.

131 See "Economic and Financial Outlook," Citibank (Polska) S.A., June 2000.
132 See "Rating & Rynek," Central European Rating Agency, May 31, 2000.

• *Tax rates* have been coming down in recent years at the corporate and personal level, and this trend is expected to continue. Meanwhile, to accommodate EU harmonization requirements, VAT on a number of goods and services increased from 7 to 22 percent in 1999. Personal income tax rates were as high as 44 percent in 1997, but they have dropped to 19, 30 and 40 percent thresholds in 1999-2000. It is projected that these rates will decline in the future. Since 1997, Poland has been lowering the corporate tax rate—which includes capital gains[133]—from 40 to 30 percent. The government plans to continue with 2 percent reductions year to year, bringing the statutory corporate tax rate to 22 percent by 2004. It is the intention of the government to reduce corporate tax rates further to provide an incentive to firms to retain earnings (and to avert an outflow of funds), and to encourage greater compliance with tax payment requirements. Social security taxes are high at 19.5 percent, split between employers and employees up to a salary cap of PLN 54,780[134] in 2000. Dividends are generally taxed at about 10-20 percent, depending on whether Poland has a bilateral treaty with another country, as it does in 59 cases[135].
• *Collection* of tax revenues is primarily based on a fairly high level of tax rates, although these are declining at the personal and corporate levels while indirect tax rates have increased. Overall, general government revenues have fluctuated between 42-48 percent of GDP over the years, while expenditures have been in the 45-48 percent range. Gross collections have increased in recent years, but declined as a percentage of GDP. The government is hoping that lower rates will increase compliance and collections, and that a more efficient payments system will also improve overall collection efforts. Most collections have been from VAT, excise and customs duties, approximating 51 percent in 1998. Personal income tax collections were about 25 percent of total fiscal revenues in 1998. Only 12 percent of total tax revenue collected in 1998 was from corporate taxes (when rates were still high, at 36 percent). However, more recently, corporate collections have increased as a percentage of total. This could be due to rates having come down to 30 percent.
• NBP *reports* on a monthly basis on public finance. This includes a variance analysis of actual and targeted central budget figures. The Central Statistical Office also reports central government figures in a timely manner.
• *MIS* for fiscal matters appear satisfactory based on data reported, and the reasonable range of fiscal deficits throughout the 1990s. There has been less volatility associated with Poland's deficits than found in other transition economies. In fact, in recent years, GoP has been fairly explicit about its projected deficits. These have also been scrutinized by the MPC as one of the major variables in determining monetary policy. However, MIS was one of the main weaknesses at ZUS, and this complicated the initial implementation of pension reform.
• *Fraud and corruption* still exist in Poland, although they are broadly thought to be less of a problem today than in the early and mid-1990s[136]. The share of the unofficial economy in

133 Poland has no separate capital gains tax.

134 Equivalent to nearly $14,000.

135 See "Doing Business and Investing in Poland," Price Waterhouse Coopers, January 2000.

136 Earlier conditions included a declining economy, high corporate tax rates, bureaucratic corruption and delays, and a general unwillingness to provide information to fiscal authorities. All of this contributed to fraud and corruption.

GDP was estimated to be as high as 196 percent in 1990, but then declined steadily from 23.5 percent in 1991 to 12.6 percent in 1995[137]. More recent studies show that problems in this domain are less severe in Poland than in most transition countries. For instance, one recent World Bank/EBRD survey indicates that Poland has comparatively low levels of corruption in terms of bribery payments, kickbacks, and perceptions of the degree to which corruption permeates fundamental business practices[138]. While there is no definitive way to measure the full extent of fraud and corruption, it appears that problems are less severe today as a result of an improved economy, rising incomes, and fewer administrative and bureaucratic obstacles for small businesses. As a significant portion of tax income is derived from VAT, import taxes, customs duties and excise taxes, the authorities have shifted their focus on consumption-oriented taxation for revenues since 1997-98. These are easier to administer, which probably has reduced errors and omissions. Increasing electronic capacity should also assist in monitoring collections while widening the base of transactions for collections.

Table 4: Fiscal Indicators

(PLN *billion*)	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Total Expenditure	24.4	39.6	57.5	77.8	106.2	142.1	177.1			
Total Revenue	26.5	34.2	51.9	74.2	101.6	136.8	166.9			
Budget Deficit*	-2.0	5.4	5.6	3.6	4.6	5.3	10.2	5.9	13.3	12.6
Central Fiscal Deficit/GDP*	-3.7%	6.7%	4.9%	2.3%	2.2%	1.9%	2.8%	1.3%	2.4%	2.1%
Consolidated Deficit/GDP		6.7%	6.7%	3.1%	3.1%	2.8%	3.3%	3.1%	3.0%	3.8%

* Measure is *the deficit*, therefore a negative sign = fiscal surplus
Source: NBP, IMF, World Bank, EBRD, CASE, Citibank

2.5 Exchange Rates

One of the key policy changes introduced in Poland in 2000 has been movement to a fully free-floating exchange rate[139]. This new approach sends a signal that GoP is confident it has needed foreign exchange reserves to meet external obligations, that monetary and fiscal policy are sufficiently strong to manage domestic requirements, and that the free float is intended to serve as a catalyst for price stabilization at the macroeconomic level and competitiveness at the structural level. The implication of this move is also that the government would not intervene in foreign exchange markets to defend the currency if the exchange rate was under attack. The exception here would be if the attack undermined financial sector stability, at which point open market intervention would be an option.

At the moment, Poland's current account deficit is the most pressing problem, particularly as it has implications for monetary and fiscal policy if it does not come down. Much of the deficit is driven by consumer demand, although some of it may also reflect investment in firms to achieve greater competitiveness, with the benefits to show up in future years in the form of increased

[137] See Transition Report: 1997, EBRD.
[138] See "Transition", World Bank/William Davidson Institute/Stockholm Institute for Transition Economics, April 2000.
[139] The zloty has depreciated fairly systematically throughout the 1990s, starting with the crawling peg regime and then moving on to a floating exchange regime in mid-1996. Average exchange rates against the U.S. dollar were 0.95 in 1990, 1.81 in 1993, and 2.70 in 1996. By end 1997, the exchange rate was 3.52. At end 1999, the rate was 4.17.

export revenues.

As the EU market is the main target for Polish exporters, a freely floating exchange rate may help to keep Polish companies more competitive with other regional firms seeking to penetrate the same markets. This should set in motion a process which will make it easier for Poland to become a member of the EMU, with outright adoption of the free floating Euro. In the meantime, the move to the new exchange rate regime should serve as a stimulus to weed out uncompetitive firms, to reward competitive firms with a growing share of overseas markets, and over time to raise the quality of goods produced and level of services provided to the domestic market. **Score: 3+/4-**

- Since the early 1990s, Poland has pursued several approaches to exchange rate management. Exchange rate p*olicy, design and implementation* have long been based on a floating exchange rate regime with open market operations, although only recently did Poland move to a fully free floating currency. A crawling peg formula was used from late 1992, with gradual reductions in the peg, gradual increases in the trading band, and periodic changes in the mix and weights of currencies. For instance, in May 1996, 45 and 35 percent weights were assigned to the dollar and DM, respectively, and another 20 percent was assigned to other European currencies. The peg was at 1 percent, and the trading band was +/- 7 percent. By the time the free float was introduced in April 2000, 55 and 45 percent weights were assigned to the Euro and dollar, respectively. The peg was 0.3 percent, and the band was +/- 15 percent.

- *Exchange rates* at March, 2000 for the dollar were PLN 4.09, representing a nominal and real appreciation from end 1999 at PLN 4.17. Much of this appreciation was due to the influx of portfolio investment, which achieved record levels in March 2000. Exchange rates at March 2000 for the Euro were PLN 3.95. These rates compare with PLN 4.22 to the Euro at end 1999. This appreciation is important, considering that 70 percent of Poland's international transactions are Euro-based.

- *Data collection and forecasting* have generally been considered strong. The zloty has been convertible for most current account transactions since the mid-1990s in preparation for OECD membership (which occurred in 1996). More recently, Poland liberalized the capital account. One argument is that such liberalization and movement to full free float make it more difficult to forecast movements in the exchange rate. This is true, although it is less important than other considerations (e.g., lower inflation rates, reduced fiscal deficits) that will ultimately lead to the market-based determination of those rates. However, Poland remains vulnerable and sensitive to portfolio movements. This can work both ways, as the recent appreciation of the currency in March 2000 was correlated with record-high portfolio inflows. Just as investors may have felt the currency was undervalued, movements of comparable magnitude could also lead to a fairly rapid depreciation of the exchange rate. With regard to the financial and corporate sector, this should translate into greater use of derivatives to hedge interest rate and exchange rate risk.

- Exchange rate policy reflects Poland's focus on *regional and global* considerations. When Poland introduced a crawling peg formula, the formula was based largely on trade developments and how these were reconciled with movement in real interest rates. Such an approach was utilized as a basis for open market operations in support of one currency or another. On April 11, 2000, the MPC adopted a freely floating exchange rate strategy. This strategy has been adopted as a precursor to joining the EMU, which would require the zloty to function within the ERM2 for a period of two years. Thus, while freely floating from early 2000 on, Poland expects to peg the zloty to the Euro in the coming years.

- *Risk management* practices are generally considered satisfactory, although many firms apparently have foreign exchange exposures that are unhedged to avoid high commission costs associated with hedging. If there were a major change in the exchange rate, it could put exposed corporates in a highly vulnerable position. The situation in the corporate sector is likely to be far riskier than the situation found in the banking sector, although cross-ownership issues may mean that greater risks exist through the banking system than are currently perceived. In the banking sector, there has been a sizeable increase in off-balance sheet liabilities over the last two years in the banking system, much of it related to foreign exchange hedging activities. Major open positions are not allowed at the banks—15 percent for individual currencies, and 30 percent globally—yet much of the data is converted to zloty before it reaches NBP. It is not fully clear if there is excess exposure on a foreign exchange basis due to borrowings abroad that are re-lent in zloty, although GINB/NBP are likely aware of these movements. With the shift to a freely floating exchange rate, NBP is mindful that financial institutions and businesses will be exposed to greater exchange rate risk. Thus, it will be incumbent on firms across the board to strengthen their liquidity and exchange rate management capacity. This will require sound information systems, prudent management, and appropriate oversight from boards and, where necessary, regulators. NBP and the MPC intend to be open about exchange rate policy directions to better inform the public, and to make it more feasible for businesses to adapt to changes in policy. This is also expected to lead to development of hedging mechanisms in the marketplace, which should lead to increased fee income for banks and more sophisticated treasury operations for companies.

- Foreign *reserves* were about $25.5 billion at end 1999, nearly $2 billion lower than at end 1998 (although $5 billion more than at end 1997). The December 1999 figure equates with about six months of current account expenditures net of transfers, about the same as 1995-98. Reserves had increased over the years due to portfolio flows and, more recently, from FDI. However, in 1999, foreign reserves declined despite high levels of FDI. Fundamentally, Poland's reserves have been considered satisfactory since debt reduction occurred in 1994, although recent trends of declining reserves and increasing current account deficits are being closely monitored.

2.6 Balance of Payments

Poland's balance of payments figures have shown an enormous increase in the current account deficit since 1997, rising from $4.5 billion that year to $11.7 billion in 1999. There has been continued growth in the merchandise trade deficit since 1996. Unclassified current transactions held steady in 1998, but declined significantly in 1999. These two declines reflect a major decline in trade with eastern CIS markets. Non-factor services are also showing some decline due to reduced trade in services and rising debt/interest payments.

The capital account declined by nearly $2 billion after strengthening in 1998. As noted above, Poland experienced a $2 billion net decrease in gross official reserves despite recording high levels of FDI for the second consecutive year. However, FDI and domestic investment are strong, and this should contribute to gross fixed investment and future competitiveness.

Overall, Poland's total public and external debt is managed, and the debt service payments on these debt stocks do not seriously undermine the current account or fiscal resources. However, trends have been unfavorable recently, as debt stock has increased, foreign exchange reserves have decreased, and debt service has contributed to a weakening of the current account.

Consumer demand has been the driving force behind the current account deficit. Movement to a fully free floating exchange rate and a disciplined monetary policy focused on bringing down inflation rates should temper this demand. However, this was not yet evident after the first four months of 2000. The major question regarding Poland's weakened balance of payments profile is whether the high current account deficit reflects investment in future competitiveness, or simple pent-up demand for consumer goods. Direct investment statistics are favorable, and point to retooling in the industrial and services sectors. However, weaker export performance and high levels of personal consumption and consumer goods suggests that households may be on a spending binge, partly due to increased access to bank credit. If so, banks may see a deterioration of loan portfolio quality should the economy slow at some point. This could be direct, in the form of delinquencies and eventual write-offs, as well as in the form of reduced collateral values on exposures to firms engaged in trade[140]. The recent rise in interest rates may reflect MPC concerns about overheating in the economy, particularly to finance consumer goods, and the effect this could have on widening the current account deficit. **Score: 3-/3**

- *Current account movement* has been unfavorable since 1996, and the deficit widened to the highest level ever in 1999. Poland's current account deficit was only $1.35 billion in 1996, or about 1 percent of GDP. This increased to $11.7 billion, or 7.6 percent of GDP in 1999. Poland had maintained low current account deficits until 1997—all deficits from 1990 were below 3 percent of GDP until 1997. Poland even generated surpluses in 1990 and 1995. However, the figures have been worrisome since 1998, particularly as it has drawn down foreign exchange reserves while debt levels have slowly increased. On the positive side, NBP and the market are fully cognizant of the risks. It is unclear what contingency plans, if any, NBP has in the event that a major tightening of monetary policy results and has a material adverse effect on the financial results of banks. The onus is on the banks to monitor and manage these risks.

- The *capital account* was liberalized in 1999 with passage of the foreign exchange law. This law lifted restrictions on all internal foreign exchange transactions between banks and non-banks. The current account had already been liberalized before Poland joined the OECD.

- Debt reduction played a significant role in improving Poland's *debt profile* and *official foreign exchange reserves* held between 1994-95. Total public debt is roughly $60 billion, while external debt is approximately $45-$50 billion. Over the last few years, Poland's private sector (banks and corporate) have increased levels of external debt. Official foreign exchange reserves approximated about 55 percent of total external debt at end 1999, down a bit from

[140] A decline in the consumer goods sector could lead to the discounting of inventories at levels below effective collateral coverage.

late 1997-early 1998. This is viewed as satisfactory coverage from a stock perspective. Debt service ratios are low, although current trends point to increases after 2002. As for current account transactions, foreign reserves decreased by nearly $2 billion in 1999, equivalent to about six months of 1999 current account expenditure net of transfers.

- *Portfolio flows* have fluctuated since 1994, and Poland remains sensitive to their movements. Traditionally, some of the inflows are comparatively fixed, as they are placed on the exchanges and have shown limited movement out of Poland. However, other movements are more mobile, and have been thought to be short-term portfolio money betting on exchange rate movements. In 1998, this served as a catalyst to further appreciation of the zloty. More recently, in March 2000, Poland received $1.6 billion in portfolio investment, the largest monthly total ever recorded. Already in the first quarter of 2000, Poland received portfolio investment of $2.5 billion, as compared with $2.1 billion in all of 1997, its highest annual total recorded. This could be beneficial to Poland, particularly given its current account deficit. However, in the future, Poland will have to be prepared for the impact of comparable outflows.

- *Direct investment* has been very strong since 1995[141], particularly in 1998-99. This investment is focused on industrial sector retooling, as well in services. In the latter case, financial services have played an important role in modernization efforts. Most direct investment has come from domestic sources. However, over the last two years, Poland has also recorded impressive FDI figures. In this regard, Poland stands out as the star recipient of FDI in the region during 1998-99, reflecting high levels of interest and confidence in the Polish market by foreign investors.

Table 5: Balance of Payments Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Merchandise Trade Balance ($ bn)	2.2	0.1	0.5	-2.3	-0.8	-1.8	-8.2	-11.3	-13.7	-14.5
Current Acct. Balance ($ bn)	0.6	-0.8	-0.3	-2.3	-0.9	5.5	-1.4	-4.5	-6.8	-11.7
Remittances/Transfers ($ bn)	2.0	1.2	2.9	3.0	1.9	0.0	0.2	1.2	1.9	1.6
Capital Account and Reserves ($ bn)	-3.2	2.9	3.3	5.6	-0.9	-0.3	2.9			
Portfolio Flows ($ bn)	0.0	0.0	0.0	0.0	-0.6	1.2		2.1	1.3	1.1
Direct Investment ($ bn)*	15.1	15.2	12.8	13.4	14.7	21.6	26.7	29.7	34.7	41.3
o/w Domestic	15.1	15.1	12.5	12.8	14.2	20.5	24.6	26.7	28.1	34.8
o/w Foreign	0.0	0.1	0.3	0.6	0.5	1.1	2.8	3.0	6.6	6.5

* *Note*: Domestic direct investment is a residual, subtracting FDI from gross domestic investment; gross direct investment is determined by the percent of GDP in dollar terms through 1996, and then figures are added incrementally from NBP data on net direct investment
Sources: NBP, EBRD, IMF, OECD, World Bank, CASE

[141] In 1995, tax laws were changed to permit allowable deductions such as depreciation. This prompted an increase in investment in fixed assets, which has contributed to overall economic growth and competitiveness.

III. BANKING STRUCTURE AND SYSTEM PROFILE

The Polish banking system has been majority private in terms of asset control and equity since 1998. Majority-private banks now account for 72 percent of assets, 74 percent of net loans, 66 percent of deposits, and 79 percent of capital. The privatization of Pekao SA was instrumental in shifting some of these percentages, although private banks have been growing faster in general than public banks. Major Polish banks that are majority private include BRE, PBK, Bank Handlowy (until it is absorbed in some form by Citigroup), and BIG Bank Gdanski. Together, these four banks account for about 22 percent of assets and 14 percent of banking system equity. Meanwhile, state banks now account for about one quarter of most balance sheet measures, down from majority ownership of the banking system as recently as mid-1997.

There has been significant strategic foreign investment in the banking sector since 1998, representing new investment, incremental investment, and consolidation. Citigroup, UniCredito, ING, Allied Irish, ABN Amro, Deutsche Bank, Société Générale, HSBC, BNP Dresdner and Bank Austria Creditanstalt represent some of the major international banks in the Polish marketplace. The recent announcement of the HypoVereinsbank merger with Bank Austria Creditanstalt has major implications for the banking landscape in Poland, as this will over time lead to a merger domestically of PBK and BPH[142]. That Allianz is also a 14 percent shareholder in the newly formed German-Austrian bank[143] may also have an impact over time on the status of Pekao SA, as Allianz is a junior strategic investor in that bank.

There has been a steady harmonization of laws and regulations with international standards to make the environment conducive to ongoing investment, and this has picked up since 1996. More revisions to the legal and regulatory framework are expected by end 2000, driven largely by recommendations from BIS and the Joint Forum on Financial Stability, and the recent demise of a bank and an insurance company.

Balance sheet measures (e.g., capital, liquidity) and quality indicators (e.g., loan portfolio quality) are generally favorable. However, margins have come down in recent years, lending to the consumer sector could raise risks in the event of an economic slowdown, and banks are now beginning to venture into new activities where risk management systems may not be fully developed.

After-tax earnings have declined since 1996, although earnings in 1999 were better than the weak earnings figure registered in 1998, and would have been an extra 13 percent higher had the banking system not absorbed the PLN 470 million loss from Bank Staropolski. After-tax earnings for the banking system were only PLN 1.8 billion in 1998, about $500 million in total, or about $6 million on average per bank. Figures in 1999 were PLN 3.5 billion, or about $880 million in total and $11 million per bank. ROA figures were 0.67 percent in 1998 and 1.04 percent in 1999. Thus, while 1999 represented an improvement, these are meager figures relative to banks in EU countries. Low returns have largely reflected increasing competition, and significant investment in systems that should generate returns over time. As the market becomes more competitive, governance and management are expected to conform increasingly to higher standards. There is already evidence that this is occurring, although fundamental building blocks,

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142 This announcement received wide coverage on July 24, 2000.

143 See "HypoVereinsbank to Take Over Bank Austria for E7.7 Billion in Stock", *Frankfurter Allgemeine Zeitung*, July 24, 2000.

such as the internal audit function, are erratic in terms of performance.

Polish banks have been consolidating since 1997[144]. More recently, Citigroup announced the acquisition of 75 percent of Bank Handlowy, which will create a significant force in the corporate market and, over time, in the retail market. Privatization of remaining state banks is not likely to lead to much further consolidation, as was the case in 1998-99. The only major state banks left are PKO BP and BGZ, which will likely be privatized through shares offered on the WSE.

Foreign banks re-entered the market after 1995, and have played a considerable role in the last two years by adding capital, technology, systems and know-how. In addition to the Citigroup merger with Handlowy, UniCredito of Italy along with Allianz of Germany bought a majority stake in Pekao SA, HypoVereinsbank acquired BPH in Krakow, and Allied Irish acquired Zachodni. Meanwhile, other strategic investors have increased their shares in Polish banks, such as Commerzbank (BRE), Bank Austria Creditanstalt (PBK), and AIB (WBK). The merger of HypoVereinsbank and Bank Austria Creditanstalt will transform BPH and PBK into Poland's second largest bank, and the third largest in central Europe[145].

More generally, private banks are expanding. Their push appears to be mainly in retail banking to diversify income sources, to attract more stable funding sources, to market non-bank financial services, and to avoid the low-margin corporate business that now appears to be dominated by a few major banks. The last tendency was brought on by the narrowing of margins on exposures to blue chip customers, a trend that was already in evidence in 1997. The limited after-tax earnings in the banking system in 1998 partly reflected these trends, and some banks have shifted their focus as a result. The risk is that many banks may be willing to take on more risk to generate higher earnings, particularly as the earnings profile of most banks has been relatively weak since 1997. Many banks are now providing consumer loans for auto and appliance purchases, loans against receivables from leasing companies for asset-based lending, and overdraft facilities for customers with "plastic cards." There is also the risk that banks will seek to improve earnings performance off of higher interest rates at the risk of suffering higher levels of default by lending to borrowers that are unable to manage their finances properly during a period of rising interest rates and more volatile exchange rates.

Meanwhile, the cost of funds has declined since 1997, although recent rate hikes have led to an increase in deposit rates. However, the series of rate hikes from NBP have permitted banks to raise interest rates on loans. Currently, net spreads on loans are reported to have increased about 100 basis points in the last half-year or so. Thus, net interest margins may begin to show increases and boost bank earnings.

While banks are reported to enjoy excess liquidity, the deposit base is still relatively small, corporate issues in Poland are limited, and syndicated borrowings from external sources represent a major supplement to Poland-supplied resources. Deposits also remain concentrated in PKO BP, Pekao SA and BGZ (and, more recently, with PBK, BPH and Bank Slaski), which makes the inter-bank market sensitive to the financial condition of these banks. In the case of Pekao SA, the failure of Bank Staropolski reduced after-tax profits by about PLN 90 million. Therefore, events such as these can have an important impact on inter-bank financing.

Meanwhile, capital at most banks is still low by global standards, although recent consolidation has helped to increase average bank capital. Nonetheless, the entire funding side of the banking

[144] Examples were BIG Bank acquisition of Bank Gdanski and the Kredyt Bank acquisition of the Polish Investment Bank in 1997, the BRE acquisition of the Polish Development Bank in 1998, and the continuous melding of the Pekao SA Group involving four banks prior to its privatization in 1999.

[145] See "HypoVereinsbank strengthens its strategy", *Financial Times*, July 24, 2000.

system still remains small in Poland, even if it has grown over the last two years. **Score: 3+**

3.1 Overview

Poland's banking system is becoming increasingly competitive now that Poland has opened up the banking sector to strategic prime-rated investors. While the market has been open for years, strategic investment has intensified in the last two years. Prior to this period, NBP appeared a bit more cautious in its approach, geared more towards domestically-oriented consolidation. However, recognizing the need for new capital and systems that would make Polish banks more competitive *and* compatible with EU banks and banking systems and, by extension, global standards, NBP has sent signals to international markets that it supports the entry of investment-grade foreign institutions into its banking sector. At end 1999, foreign institutions accounted for 56 percent of banking sector equity. This, along with investment in information systems and the shift towards consumer banking, is the most salient change in the Polish banking landscape since 1997.

Banks have shown progress in management and governance based on BIS guidelines for prudential regulations, international standards of accounting, and earlier restructuring efforts. NBP regulatory oversight has played a constructive role in helping to monitor for bank risks, and to serve as an incentive for banks to develop risk management systems. Recent strategic investment should help with expansion of risk management capacity, so essential as banks push into non-banking activities.

Lending flows began to increase in late 1995 as net spreads on securities began to decline, and as banks reached levels of capital adequacy on a risk-weighted basis that permitted them to resume lending. More recently, and since 1997, there has been considerable evidence of increased lending to households, individuals, and small businesses.

Overall, balance sheet indicators indicate some decline in asset quality, with the ratio of irregular classifications to gross claims rising from about 10.5 percent in 1997-98 to 13 percent by end 1999. Commercial banks in particular showed an increase, with 13.4 percent at end 1999 (as compared with cooperative banks, which only showed 3.6 percent at year end 1999, about the 1997-98 average). There are some concerns about the risks associated with the substantial increase in consumer and small business lending—much of it installment finance. All of these trends are further compounded by the risk of higher inflation rates, which may prompt further interest rate increases, and set in motion a higher level of default that would then trigger higher levels of irregular loans. However, these risks have been a concern since 1996, and are mitigated by the requirement that banks fully provision for these losses and risks.

Polish banks appear to be diversifying, irrespective of ownership. Polish banks have sought to expand their retail operations, recognizing the importance of deposits as a reliable source of funding and, until recently, the small portion of their earnings that comes from fee-generating services. This has inevitably led to more consumer services, particularly as new information systems have been brought on stream.

Meanwhile, foreign-controlled banks have been increasing their balance sheet exposure—lending and retail services—now that the blue chip market is saturated, and rates for a range of services have come down. For instance, foreign banks are now responsible for 51 percent of net loans, as compared with 22 percent in 1998. While this is partly due to the privatization of Pekao SA, it is also due to a general increase in lending by banks, Polish and foreign.

After-tax 1999 earnings showed that cost structures remain high—costs were 93 percent of gross income, up from 85 percent in 1997. State banks' cost-income ratios were 92.4 percent, while private Polish banks showed 88.4 percent, foreign-owned banks showed 95.0 percent, and cooperative banks showed 87.6 percent. Thus, the high ratios appeared to be driven primarily by expansion plans and investment in personnel and systems by foreign banks. Poland's 16 listed banks showed cost-income ratios of 92.2 percent. Return on assets and equity both increased in 1999, but this was mainly due to the low returns in 1998. For the system as a whole, NBP figures for 1999 show ROA at 1.0 percent and ROE at 14.2 percent. While higher than figures in 1998[146], they are considerably lower than 2.0 percent ROA and 24.7 percent ROE in real terms for 1997, and 2.5 percent and 41.9 percent, respectively, in 1996.

Now that corporate sector competition is strong, the next trends appear to be intensifying competition at the retail level, and the provision of a wider range of services that cut across financial services markets (by product and region). Upcoming challenges at the *system level* include the ability to identify and contain risks as banks venture into new and riskier activities, strengthening coordination at the technical level among various regulatory authorities in concert with the Committee for Banking Supervision, the outcome of consolidation in the coming years, the method and result of privatization of BGZ and PKO BP (particularly from the funding side), the potential for other bank failures as a result of poor information and questionable cross-border transactions, and the role of the judiciary in settling disputes in a timely fashion that also reinforces incentives for prudent management of credit.

At the *firm level*, key risks for banks and financial services companies include development of autonomous internal audit functions and enhanced internal controls for strengthened governance and oversight of management, the expansion of risk management capacity as banks increase their presence in a variety of financial services, the success of investment in management information systems that produce needed information in a timely manner for management to identify and contain risks as they surface, the strategic direction of various banking firms under open and highly competitive conditions, and the synergies achieved from investment in non-bank services with banking franchises. Many of these challenges existed two years ago, and will be ongoing.

The presence of major global players in the Polish market helps with many of these risks. It is expected that the more successful foreign banks will succeed because they will have formed more fruitful partnerships with local Polish institutions, thus achieving a more accurate reading of the local market. It remains to be seen how long the major Polish institutions will be able to compete with global power houses in the absence of further consolidation or strategic investment. Trends point to these firms increasing strategic investment, although this approach has initially been ruled out for PKO BP. The impact of consolidation will also have a direct impact on the Polish banking landscape, with Citigroup and HypoVereinsbank-Bank Austria possibly representing driving forces in the coming years. **Score: 3/3+**

- In terms of assets, Poland now is majority private as a banking system. Poland's 70 private banks accounted for 72 percent of total assets at end 1999, or about PLN 262 billion ($65 billion). By contrast, Poland's seven public banks accounted for 24 percent of total assets, or PLN 87 billion (about $22 billion). The balance was held by cooperative banks. These proportions represent a dramatic change from a few years ago, when state/Treasury-owned banks accounted for the majority of assets of the banking system. However, on average, public banks still remain significantly larger than private banks. This is of particular importance

[146] In 1998, ROA was 0.7 percent and ROE was 9.2 percent.

	with regard to deposit mobilization, with PKO BP alone accounting for about 40 percent of savings accounts. With only seven public banks that account for 24 percent of total assets, the average size of the public banks was PLN 12.5 billion (about $3 billion) at end 1999, about 3-4 times the size of the average private bank. In particular, PKO BP and BGZ are large on a balance sheet basis, with the other five being small institutions. Meanwhile, private banks are numerous, and smaller on average. Based on total assets, the average private bank had about PLN 3.7 billion (about $1 billion) in assets at end 1999. Among the private banks, majority Polish-owned banks were considerably smaller than majority foreign-owned banks. Private Polish banks averaged PLN 2.9 billion in assets at end 1999, compared with PLN 4.4 billion for foreign-owned banks. Thus, public banks are about four times larger than private Polish banks, and about three times larger than private foreign banks. In terms of asset size, the five largest banks at end 1999 were PKO BP (17.5 percent), Pekao SA (17.5 percent), Bank Handlowy (5.5 percent), PBK (5 percent) and BGZ (5 percent)[147].
•	With regard to *loans*[148], private banks accounted for 74 percent of loans at the end of 1999. This is equivalent to about PLN 114 billion (about $28.5 billion), and compares with the public banks' PLN 33 billion (about $8 billion). Thus, as with general trends in assets, Poland has clearly shifted to a private banking system. However, the average size of the public banks' loan portfolios was about PLN 5 billion (about $1.25 billion) at end 1999, far larger than that of the private banks. (These figures are partly inflated by a large stock of nonperforming housing loans at PKO BP.) These figures compare with about PLN 1.6 billion (about $400 million) on average for private banks at end 1999, with foreign banks being larger in average loans than Polish banks. Private Polish banks averaged PLN 1.1 billion (less than $300 million) in loans at end 1999, compared with PLN 2 billion (about $500 million) for foreign-owned banks. Thus, private banks had less exposure on their balance sheets than the state banks. In terms of total loan size, the five largest banks at end 1999 were Pekao SA (17.2 percent), PKO BP (15.8 percent), Bank Handlowy (6.5 percent), BGZ (6.1 percent), and Bank Slaski (5.9 percent)[149].
•	In terms of *deposits*[150], private banks account for about two thirds of total deposits. Private banks held PLN 139 billion (about $35 billion) in deposits at end 1999, compared with public banks' PLN 62 billion ($15.5 billion). Thus, while loan and asset shares are relatively small among the public banks, their share of deposits is still fairly substantial. PKO BP alone accounts for about 26 percent of total deposits in the banking system. The average size of the public banks' deposits was PLN 9 billion (about $2.2 billion) at end 1999. This compares with an average of about PLN 1.8 billion ($440 million) for private banks at end 1999. Private Polish banks averaged PLN 1.4 billion in deposits at end 1999, compared with PLN 2.5 billion for foreign-owned banks. The latter is skewed by foreign ownership in Pekao SA, which has

147 Asset figures derived from "The First Polish Economic Guide: 2000", Warsaw. Percentages based on these asset figures, and divided by NBP year end total asset figures.

148 PLN and dollar figures are estimates. NBP does not report net loan figures, just percentages of net loans to total by type of bank. Gross claims on the non-financial sector are reported in zloty. Relative percentages of net loans are applied to gross claims for figures. However, these should only be interpreted as rough approximations due to the absence of information.

149 Loan figures derived from "The First Polish Economic Guide: 2000", Warsaw. Percentages based on these loan figures, and divided by NBP year end loan figures "gross claims of commercial banks on non-financial sector).

150 These figures are derived from relative shares of deposits taken from the non-financial sector as a percentage of total assets by type of bank.

about 21 percent of total deposits in the Polish banking market. In terms of total deposit size, the five largest banks at end 1999 were PKO BP (26.1 percent), Pekao SA (21.2 percent), PBK (6.1 percent), BGZ (5.2 percent), and BPH (4.9 percent)[151].
• On an *equity capital* basis[152], private banks accounted for about PLN 27 billion (nearly $7 billion), or 79 percent of total. This compares with the public banks' PLN 5.6 billion, or about $1.4 billion. Thus, ownership of the system is now broadly in the hands of the private sector at this juncture, notwithstanding the two large non-private banks. However, again, because of the small number of public banks and large number of private banks, the average capital of the public banks was larger. Public banks averaged PLN 800 million ($200 million) in capital at end 1999[153]. This compares with about PLN 389 million (about $100 million) for private banks at end 1999. Private Polish banks were smaller than foreign-owned institutions. In terms of capital size, the five largest banks at end 1999 were Pekao SA (11.4 percent), PKO BP (10.1 percent), Bank Handlowy (9.5 percent), BPH (7.5 percent), and Bank Gospodarstwa Krajowego (6.0)[154].
• There is substantial *concentration* at the top of the system among the 5-15 largest banks, and this concentration is steadily increasing. The five largest banks accounted for 48 percent of assets, 46 percent of loans, and 55 percent of deposits at end 1999[155]. This compares with 43 percent, 51 percent and 36 percent, respectively, with 1998 figures. Thus, in all categories, the five largest banks now account for about half of balance sheet values. Among the largest 15 banks, the ratio is now at about 80 percent, compared with 75 percent in 1998. In absolute size, the top five banks in Poland are mid-sized by EU standards. The average asset size of Poland's five largest banks was PLN 33.3 billion[156], or Euro 8.0 billion[157]. Thus, while the Polish banking system is showing movement towards consolidation, it is still comparatively small when measured against major EU banks.
• As noted earlier, public banks dominated the system until 1999, where they were about four to five times the size of private banks in terms of net assets and loans. Public banks clearly enjoyed a *funding* advantage, largely due to deposits kept with PKO BP and Pekao SA, which skewed the average. With privatization of Pekao SA in 1999, the figures have changed dramatically. In general, deposits still account for the bulk of balance sheet funding sources for commercial banks. Deposits from the non-financial sector accounted for about 62 percent of funding by end 1999, little changed from 1997-98. The share of deposits placed with public banks declined from 50 percent in 1997 and 46 percent in 1998 to 28 percent in 1999, of

151 Deposit figures derived from "The First Polish Economic Guide: 2000", Warsaw. Percentages based on these deposit figures, and divided by NBP year end deposit figures for demand and time deposits.

152 Figures are derived from total PLN figures for capital and retained earnings by shares of capital by type of bank.

153 It should be noted that these are regulatory capital figures. It is possible that more market-based valuations would render capital figures lower after a due diligence is conducted. For instance, PKO BP has already alluded to the need for some special financing for its nonperforming housing loan portfolio for privatization to move forward. Without such a bail out, it is conceivable that capital figures would be lower than reported to/by NBP.

154 Capital figures derived from "The First Polish Economic Guide: 2000", Warsaw. Percentages based on these capital figures, and divided by NBP total capital figures for banks.

155 Loan and deposit figures to/from the non-financial sector.

156 (.477 x PLN 349 billion)/5 = PLN 33.3 billion.

157 Year-end 1999 exchange rate: Euro 1 = PLN 4.17.

which most is with PKO BP. Meanwhile, private banks hold about 66 percent of deposits, up from 37 and 41 percent in 1997-98, respectively. In particular, foreign-owned banks now account for about half of deposits, as compared with about 13 percent on average from 1997-98. Thus, while deposits placed with public banks have declined, they still represent a significant (albeit declining) share of commercial banks' funding liabilities. However, it is now clear that private banks are competing for deposits and grabbing an increasing share of funds placed with banks. This does not necessarily mean that private banks are grabbing an increasing share of total savings, as the public is also placing savings with investment houses, insurance companies, pension funds, and other vehicles. However, within the commercial banking sector, private banks (and mainly foreign banks) are now increasing their share of deposits. Moreover, because many of these banks have brokerages, pension funds, and insurance units, they are generally mobilizing higher shares of available savings on a consolidated basis.

- The second leading source of funding is the *inter-bank market*. This accounted for about 17 percent of balance sheet funding at end 1999, also little changed from end 1998. Public banks hold a significant share of the resources made available to this market. Private banks are increasingly investing in electronics to close the gap in the deposit market, with the intention of mobilizing a greater share of these resources for a more reliable funding base.

- In the absence of a large deposit base or corporate bond market, amount and quality of capital is essential for stable banking practices. The comparatively weaker *capital position* of public banks on a risk-weighted basis is more evident when measured against total assets. On average, public banks had equity equivalent to 1.3 percent of assets, as compared with private banks' equity of 2.4 percent. Among the private banks, Polish-owned banks had equity equivalent to 2.2 percent, as compared with foreign banks' 2.5 percent. Adjusted capital[158] figures are not reported by state-Treasury-owned banks against private banks. However, published figures indicate that majority-Polish banks[159] had PLN 10.1 billion in adjusted capital, or about 5.7 percent of total assets, as compared with foreign private banks'[160] PLN 14.5 billion, or 8.4 percent of total assets. In terms of how this relates to funding, there is only one small public bank[161] among the 16 listed on the Warsaw Stock Exchange. Thus, the 15 listed private banks are in a better position to raise equity under transparent conditions than their counterparts in the public sector. The state/Treasury-owned banks continue to present a threat in terms of access to public finances or other patronage benefits, although this risk seems to have abated in recent years.

- The *earnings stream* of the various banks improved in 1999, but has been weaker in recent years as net spreads have narrowed on lending and securities investment, as banks have tooled up new systems and hired/trained personnel to provide more services, and as competition has intensified in the corporate sector. General trends from 1999 earnings statements indicate a general decline in interest income and expense due to lower interest

158 Adjusted capital is defined by NBP as the sum of core and supplementary capital less unabsorbed prior and current losses (pending confirmation), equity holdings in other financial institutions, shortfalls in specific provisions, and Treasury stock. From 2001, intangible assets will also be excluded.

159 These banks accounted for 48.5 percent of total assets.

160 These banks accounted for 47.2 percent of total assets.

161 Bank Ochroney Srodowiska SA is indirectly owned by the Treasury.

rates, a general rise in fee income and expenses, improvements in net income from core banking operations, and increased net income due to improvements in the performance of public banks. Total earnings were only PLN 3.5 billion for the banking system at large, of which private banks accounted for 67 percent, state/Treasury-owned banks 27 percent, and cooperative banks 6 percent. These results represent an improvement over 1998, but are lower than net earnings registered in 1996-97 when the banking system posted net earnings of about PLN 4.5 billion (about $1.5 billion each year). Surprisingly, state/Treasury-owned banks actually performed better on an ROA and ROE basis than private commercial banks, although this may be partly because the two largest state/Treasury-owned banks did not have to cover any of the PLN 470 million loss from Bank Staropolski incurred by the rest of the banking system. This may also have been due to effectiveness in cost containment efforts. In the case of PKO BP, improved earnings may also have resulted from improved asset management in the last two years, given the large deposit base it enjoys. Both foreign banks and listed banks (the major Polish private banks) performed far better than the smaller private Polish banks. Listed banks[162], of which about half have minority or majority foreign investment, generated PLN 2.4 billion (about $600 million) in net earnings, or about PLN 150 million (about $38 million) on average. This was 68 percent of total net earnings for the system. Majority-foreign banks generated about PLN 1.2 billion (about $300 million) in net earnings, or about PLN 32 million (about $8 million) on average. This indicates that the foreign banks still have much smaller operations than many of their Polish competitors, and their earnings are still fairly meager relative to global operations. In terms of earnings on a net basis, the five most profitable banks in 1999 were BRE , Bank Handlowy, BGZ, PBK and Bank Slaski. In terms of ROA, the five best performers were BRE, Bank Gospodarstwa Krajowego, LUKAS Bank, Bank Ochrony Srodowiska, and Bank Handlowy. In terms of ROE, the five best performers in 1999 were BGZ, BRE, WBK, Gornoslaski Bank Gospodarczy, and Prosper Bank[163]. It should be noted that financial results on smaller banks and state banks throughout the region, including in Poland, have sometimes been misrepresented or overstated. Thus, too much should not be made of some of the ROA and ROE figures of smaller banks.

- *Competition on the asset side* has been increasing on the consumer lending side, having become saturated in the corporate lending arena. This brought down net spreads until recent rate hikes by the MPC. Banks have consequently shifted resources, primarily into increased lending to the non-corporate sector (i.e., individuals, households and small businesses) and the inter-bank market, and away from Government securities[164]. At end 1999, Poland's banks had 44 percent of their assets in loans to the business/household sector, 24.5 percent in securities (mainly Government), and 16 percent in loans to other banks. This compares with 40 percent in loans to the business/household sector, 28 percent in securities (mainly Government), and 14 percent in loans to other banks at end 1998. Thus, lending has increased while securities investment has generally stabilized in tandem with government fiscal deficits of about 3-4

[162] These are Bank Handlowy, Bank Slaski, BPH, WBK, PBK, BRE, BIG Bank Gdanski, Pekao SA, Bank Komunalny, Kredyt Bank, Bank Ochrony Srodowiska, LG Petro, Pierwszy Polsko-Amerykanski (which recently changed its name to Fortin Bank), Bank Czestochowa, AmerBank, and Bank Wspolpracy Regionalnej.

[163] Earnings and return figures all derived from "The First Polish Economic Guide: 2000", Warsaw.

[164] Investment in securities as a percent of total assets began to decrease in 1996. At end 1996, they represented 31 percent of total assets. By end 1997, they were 26 percent. Investment in securities has decreased as a proportion of total assets due to declining yields as the fiscal deficit decreased and stabilized in the 3-4 percent range.

percent. As for the distribution of loans, the highest growth was for installment loans to individuals. While these accounted for only 8.3 percent of total loans at end 1999, they grew by 54 percent in 1999. Loans to individuals and companies with fewer than 250 employees are reported to account for 40 percent of all bank loans[165]. Overall, consumer loans were 18.3 percent of total loans at end 1999, showing a 47 percent growth rate. Loans to persons as a whole were 22 percent at end 1999. This represents an increase of PLN 12 billion (about $3 billion) in lending to households, individuals and small businesses in 1999. All of these trends are vastly different from the mid-1990s, when only large corporates received loans, and banks generally invested in Government securities rather than lending. Loans have traditionally been secured[166], although increased competition may lead to a growing proportion of unsecured loans in the future. Securities are almost exclusively issued by the Treasury or the NBP[167]. Moreover, banks have limited investments in equity securities, which represent only about 2 percent of total securities investments of the banks, or about PLN 1.5 billion (about $375 million). Polish banks have a higher proportion of securities investments than foreign banks[168], although the trend is toward convergence. Other asset categories showed limited change in terms of magnitude except what was due from government net of securities investments. This reflected lower reserve requirements (which reduced what was due from the central bank[169]), although reinvestment in bonds led to an increase in what was due from government[170]. The net difference freed up 2.4 percent of total assets for new lending, equivalent to about PLN 8 billion (about $2 billion), about two-thirds of the incremental lending to the household/small business sector and equivalent to about 1.3 percent of GDP.

- The banks' *funding* is characterized by a high proportion of deposits to total, and by high levels of concentration, although this is diminishing as banks expand retail operations. Concentration is largely due to the traditional concentration of deposits held by three banks—PKO BP, Pekao SA, and BGZ—and to the limited additional financing available for banks. Concentration is largely unchanged since 1997, although other banks' investments in retail operations are shifting the proportions a bit[171]. State/Treasury-owned banks accounted for 28 percent of total deposits. Most of this was with PKO BP (and then BGZ), accounting for about PLN 64 billion (about $16 billion, equivalent to 10 percent of GDP). Combined with Pekao SA, recently privatized, these three banks account for about half of all banking system deposits, which would represent an increase of nearly PLN 15 billion since end 1997. However, it also represents a decline in the overall share, as they held 56 percent of total deposits at end 1997. Thus, individuals and businesses are both beginning to place more

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165 See "Business Central Europe", April 2000.

166 One source claims only about 3 percent of comparatively new firms are unable to obtain unsecured loans in central Europe. See Bratkowski, A., I. Grosfeld, and J. Rostowski, "Investment and Finance in *de novo* Private Firms: Empirical Results from the Czech Republic, Hungary and Poland," Center for Social and Economic Research, Warsaw, 1998.

167 These two institutions accounted for 92 percent of debt securities, down slightly from 95 percent in 1998.

168 Polish banks showed 27 percent of total assets in securities in 1999, compared with foreign banks' investments of about 22 percent of total. Trends show Polish banks are decreasing their proportional share, while foreign banks are increasing their share of investment in securities.

169 From 6.4 percent at end 1998 to 2.8 percent at end 1999.

170 From 2.3 percent at end 1998 to 3.5 percent at end 1999.

171 For instance, three of the five largest banks are private—Bank Handlowy, Pekao SA and Bank Slaski. The top five banks now account for 55.4 percent of deposits, as opposed to 51 percent in 1998. There was an 83.5 percent share of deposits held with the 15 largest banks at end 1999, as opposed to 79 percent at end 1998.

deposits with these three banks' competitors, both in volume and as a percent of total. This indicates that some of the investment in retail for private banks is beginning to pay off, particularly as most of the increase has come from individuals in the form of time deposits. Advances in consumer finance through debit and credit cards, payroll processing for companies, compensating balances for loan accounts, savings/pension plans, insurance and brokerage offerings, and other services provided by a more competitive banking system serve as an incentive to households and enterprises to place more funds with banks. Foreign banks in particular appear to be benefiting from this trend. Even netting out the shift in figures as a result of the Pekao SA privatization, foreign banks' share of total deposits increased dramatically in 1999[172]. Overall, deposits as a share of total liabilities and capital remain high, at about 60 percent. This figure has slowly increased since 1997, and continues to reflect the absence of non-deposit funding in the market for banks. The other major source of funding is from the inter-bank market, which accounted for about 17 percent of total bank liabilities at end 1999, little changed from 1998. As a supplement, many of the larger banks have accessed the international syndicated loan market as a substitute for a domestic bond market for years. Foreign borrowings were about PLN 21 billion (about $5 billion) at end 1999, little changed from figures since 1996. As interest rates have come down in recent years in Poland, there has been less pressure on banks to borrow abroad, particularly with the net effect of changes in reserve requirements. Nevertheless, rates abroad are still lower, and they represent more attractive financing arrangements.

- Poland's banks have excellent *correspondent networks*, and *payments systems* are considered more than adequate and improving. Most of Poland's largest banks, both public and private, already had well established networks years ago. Such networks have improved as banks have restructured, as more strategic investment is now entering the Polish banking sector, and as the electronic payment system moves towards EU standards.

3.2 Ownership

Poland's banking sector has gone through rapid transformation of its ownership figures in recent years. In early 1997, banking was still primarily driven by state/Treasury-owned banks, although liberalization and rising interest from foreign banks were materializing. Today, banking is dominated by 16 listed banks (of which 15 are private), of which about half have foreign investment, and several large unlisted foreign banks that are competing in the corporate and retail markets. The combination of listed and foreign banks is also heavily involved in non-bank activities, with primary shares in brokerage, insurance and pension funds.

Apart from the prominent role of PKO BP and BGZ in deposit mobilization, banking is now largely driven by the private sector. Past reticence on the part of NBP and GoP to accelerate privatization via strategic investment has given way in the last two years to major

[172] Foreign banks' share of deposits increased from 13.7 percent at end 1998 to 45.7 percent at end 1999. Even netting out about 20 percent from Pekao SA, this would represent an increase of about 12 percent of the total share of deposits. Thus, net of Pekao SA, this represents about twice the share of deposits foreign banks had in 1996-98, and about eight times their share in 1993-95.

investment from prime-rated foreign institutions. While political considerations will undoubtedly affect the type of privatization method ultimately used for PKO BP and BGZ[173], the focus today is primarily on increasing capital, providing world class financial services, demonstrating progress towards meeting EU and EMU standards, and conducting financial sector activities in a safe, sound and stable manner. Private banks are now responsible for 79 percent of the total capital base of the banking system (as of end 1999), of which 50 percent is with majority-foreign banks[174]. Public attitudes have changed favorably about banking and banks in recent years, resulting from improved levels of service, greater access on the part of small businesses and individuals to credit, and obvious commitment on the part of investors to building retail operations. This should not be interpreted as full proof with regard to risk and stability. However, banking has evolved in Poland as a fundamentally sound and competitive sector of the economy. **Score: 3+/4-**
• The *ownership structure* of the banking system has changed in the last two years, reflecting a significant increase in foreign investment, and gradual but steady consolidation. There were 77 banks at end 1999[175] excluding those declared bankrupt or under liquidation. In addition, there were 781 cooperative banks. This compares with 83 banks in Poland at end-1997 along with 1,295 cooperative banks. Among the 77 commercial banks, 39 had majority/total foreign equity and 38 were majority/wholly Polish-owned. This represents a major change in the landscape from 1997, when only 29 of 83 commercial banks were foreign-owned. Private sector banks outnumbered public sector banks, at 70 and 7, respectively. This represents a gradual but continuing shift towards privatization of the Polish banking landscape. In 1997, there were 68 private banks and 15 majority-public sector banks[176]. Thus, while the number of private banks has not increased dramatically, the contraction of public banks has. Further, these are inter-related, as foreign strategic investors have stepped in since 1998 to accelerate privatization and consolidation trends. Thus, since 1993, there has been a slow but steady trend of winding down public ownership in the banking system, and limited net growth in the number of private banks.
• The ownership structure of the banking system based on NBP figures reveals *segmentation* into four different groups—majority public sector, majority Polish private banks, majority foreign-owned private banks, and cooperative banks. Events in 1999 represented a turning point for Poland in terms of some of the aggregate balance sheet measures by ownership segment. For the first time, private banks accounted for a majority of banking system assets, and majority foreign-owned banks became the largest group among the four groups cited above. Public banks accounted for the largest share of most balance sheet indicators through

[173] Employees and managers are likely to be given shares, and citizens at large may benefit through capitalization schemes for the pension system.

[174] Total foreign investment in the banking system was about 56 percent of equity at end 1999.

[175] In fact, on a *de facto* operational basis, there were fewer banks, as seven or so banks are owned by other banks. For instance, BIG Bank Gdanski has four other banks that are subsidiaries. Along with other mergers and acquisitions that were in process or concluded in 1999, this would effectively bring down the number of banks to about 70. The bankruptcy of one and the exit of a foreign branch would effectively bring down the number of total banks in Poland to about 68 on this basis.

[176] In 1993, there were 58 private banks and 29 public sector banks, with the latter representing 80.4 percent of banking system assets.

1998—46 percent of assets, 39 percent of net loans, 54 percent of deposits, and 33 percent of capital[177]. By end 1999, private banks as a whole accounted for 72 percent of assets, 74 percent of net loans, 66 percent of deposits, and 79 percent of capital[178]. Thus, particularly as a result of the privatization of Pekao SA, 1999 represented a turning point for Poland in effectively making the banking system a primarily private sector-oriented system. Meanwhile, foreign banks have likewise begun to play an increasingly important role, with 1999 also representing a turning point. At end 1999, foreign private banks accounted for 47 percent of assets, 51 percent of net loans, 46 percent of deposits, and 50 percent of capital[179]. By contrast, Poland had 29 majority foreign-controlled banks at end 1997. These banks accounted for only 12.5-17 percent of net assets, loans to the financial sector, and deposits, and about a quarter of core capital. Cooperative banks generally account for 4-5 percent of most measures, although this excludes regional and local affiliates.

3.3 Governance and Management

Governance in Poland has been reasonably strong and/or improving for many years. The process began in 1992-93 when hard budget constraints were imposed, twinning arrangements were introduced, portfolio restructuring efforts began, banking supervision began its institutional development process, and banks started to effectively recapitalize. More recently, efforts have been made to address weaknesses at the supervisory and management board level. This has come from prodding by the GINB, coordination with the CBS (via the Polish Banking Association), broader acceptance of the need for strong risk management systems after the Russia/East Asia/emerging markets turbulence of 1997-98, and significant increases in foreign investment.

Bank Handlowy and BRE were both considered to have sound reputations for governance and management in 1997. Other Polish banks had varying reputations, but were considered less strong than these two banks. In particular, while several banks improved their balance sheet management during the mid-1990s, there were doubts about governance and management capacity for risks in a universal banking regime under competitive, open market conditions. For instance, banks showed greater prudence in credit management, but this was more in the form of conservative judgments and heavy collateralization coming off a period of high levels of Government securities investment. Banks did not necessarily have adequate systems in place for unsecured lending, foreign exchange trading, or other risks that could surface. Nor were banks focused on improving service levels and introducing a wide array of retail services. This has clearly changed in the last two years, with competition evident in the corporate and retail markets.

However, there still appear to be potential weaknesses at many banks. The internal audit function is not as autonomous or developed as it needs to be at many banks. Internal controls are not always in place. There are reported to be high levels of unhedged exposures. Lending to the consumer sector has sometimes relied on third parties and credit agencies. There are dubious forms of cross-ownership that raise questions about the potential for losses to the system, as occurred with Staropolski. More generally, given that the economy has shown real annual growth 4-7 percent since 1994, there is also the possibility that some portfolios are vulnerable to broader

177 All figures from "Summary Evaluation of the Financial Situation of Polish Banks: 1999," NBP, April 2000.

178 All figures from "Summary Evaluation of the Financial Situation of Polish Banks: 1999," NBP, April 2000.

179 According to NBP, foreigners account for 56 percent of all commercial bank equity.

economic decline, and that the strong economy has obfuscated some of the underlying weaknesses of portfolios. Further, while Staropolski was not bailed out, there are questions about the role of the Bank Guaranty Fund's assistance fund, the potential for forbearance and lender of last resort financing to large banks that may not always be as soundly managed and supervised by the boards as needed, and the signals these send with regard to incentives for strong corporate governance.

Poland was reputed to have supervisory board weaknesses in 1997-98—an absence of experienced financial sector personnel to provide needed oversight—and associated internal audit weaknesses. While supervisory boards are now stronger, GINB has cited the need for a strengthened and autonomous internal audit function at many banks. This would require greater separation of functions, better information systems and internal controls, better compensation for internal auditors, and reasonable protection for internal auditors when informing the supervisory board of unwelcome findings and advice. Some of these measures have been put in place in recent years, but GINB believes performance at banks is erratic.

As the market has become more competitive, the onus is shifting increasingly to boards to ensure their management teams have devised and are implementing appropriate strategic plans with corresponding risk tolerance levels to the various activities that are part of that strategy. This requires financial, legal, technical and business skills to comprehend the growing complexities of risks the banks will soon face with universal banking in place and integration with the EU intensifying.

Management will need to ensure the personnel, systems and procedures are in place to implement their strategies, and to identify, contain and communicate unanticipated risks when they materialize. There is strong evidence that foreign banks have these systems in place, and that the larger Polish banks generally do so as well.

To the extent that the state/Treasury-owned banks may have weaknesses, their financial results in the last year or so seem to indicate they are pursuing a relatively cautious approach to asset management so as to not undermine deposit safety. Poland's banks have generally shown progress over the years. This has been most noteworthy in terms of the financial and operational restructuring of most state-owned banks since serious reforms began in 1993. **Score: 3+**

- According to the Company Law, the *legal* process for forming and registering a company in Poland is fairly straightforward. The process takes one to three months, although in some cases it can take up to a year. There are clear guidelines for types of corporate structure, and the general obligations of directors. There are also restrictions on insider dealing of shares in publicly listed companies. As for banks, the Banking Act elaborates requirements expected of banks' boards and management teams, specifies minimum capital and capital adequacy requirements for a license, limits insider dealings to 10 percent of a bank's core capital, defines other limits on a range of exposures, stresses internal audit and disclosure requirements, and describes penalties for legal violations. These penalties are expected to be toughened later in 2000. Creation of a new inspectorate to monitor for money laundering, fraud and other crimes is likely to put new pressure on boards and management to ensure their practices, systems and controls do not violate regulatory norms or undermine financial sector stability.

- *Cross-ownership* has been permitted since 1997 as legal barriers to universal banking are coming down. However, there are clearly specified limits on the amount of exposure banks can have in non-bank companies. This includes limits on bank shares in individual companies

	or funds to 15 percent of bank capital, and total exposure of bank investment in companies and funds to 60 percent of bank capital. There is an allowance for banks to convert debt to equity, but on the basis that such equity will be sold within three years. The Commission for Banking Supervision is empowered to request and share information with other regulatory bodies in the pension, insurance and investment fields to ensure that banks and other institutions remain in compliance with regulations. With recent problems at Bank Staropolski and Polisa Insurance, it is expected that there will be increasing oversight. However, this will require better monitoring of the use of non-banks for potentially fraudulent activities, or exposures that could impose exceedingly high or costly levels of risk on the financial system. This will also require better coordination among regulatory authorities within Poland at the technical level, and more effective coordination on a cross-border basis. On the latter point, this is problematic around the globe. Poland appears to lack formal mechanisms with many of its EU and OECD counterparts, and capacity in many neighboring countries is weak. At a minimum, Poland needs to provide regulatory authorities with the powers and information it needs to supervise firms on a consolidated basis. Failure to provide for such oversight may encourage activities that weaken financial sector stability, particularly as weaknesses in judicial capacity persist.
•	*Minority shareholders* are protected in Poland under Company law. They have the right to pool their votes to ensure at least one member who represents their interests sits on the board. Shareholders are also given preemptive rights on the issuance of new shares. This helps to protect a minority position from being diluted, at least on non-commercial grounds. This was in evidence several months ago when BRE nearly acquired Bank Handlowy, but was unable to do so after PZU and the Treasury mobilized 25 percent of shareholders to block the move on the grounds that the premium being paid for shares was inadequate[180]. However, companies are not required to send proxy forms to shareholders in advance of meetings. Poland's performance in this area has been satisfactory. As Poland is seeking to expand its capital markets activity and to gain entry into the EU, protection of minority shareholder rights will be satisfactorily maintained in accordance with OECD standards. The surge of FDI in Poland since 1998 reflects the market's confidence in minority shareholder protection in Poland. This has been true in the banking sector as well, as many banks have minority foreign investment (some of which has subsequently gone on to become majority).
•	Governance in the banking sector has improved since the restructuring of the seven state-owned commercial banks began in 1993. The hard budget constraint imposed on non-private commercial banks played a significant role in strengthening internal governance and management. This led to better *oversight* of management performance (based on strategic targets to position the banks for subsequent privatization), improved information and reporting systems, high standards of accountability, and the adoption of new credit procedures under commercial conditions. Recent foreign investment into the banking system is expected to strengthen systems and controls for better oversight of management.
•	There are no restrictions on *compensation*—salaries and benefits—of bank directors, managers and employees. However, the Commission for Banking Supervision can restrict

[180] Citigroup later acquired Bank Handlowy at a 20 percent premium over what BRE and its leading shareholder, Commerzbank, were willing to pay. See *Business Central Europe*, February 2000.

salaries, benefits, dividend payments and other bank expenses in the event of needed corrective action. Generally, compensation levels are rising in the financial sector.

3.4 Non-Bank Competition

The non-bank sector is beginning to expand in some areas, and to consolidate in others. Growth is steady but plodding in the capital markets and insurance sectors. The recent introduction of pension reform should serve as a spur for both, with insurance companies playing a major role in the pension fund business, and 30 percent of proceeds being invested in WSE equities. In other cases, there has been slow progress—notably with the privatization of PZU in insurance, and development of the leasing sector—or growth of consumer and commercial finance companies that can pose a problem to the banking sector if not properly overseen.

At the small-scale level, credit unions have formed in many Polish cities and towns, serving as a provider of financial services to many people who earlier were unable to access banking services. The cooperative banks' financial condition appears to have stabilized for the time being.

Progress appears to have slowed on a number of fronts since 1997-98. While the PZU privatization is moving forward, the pace is slower than originally anticipated. A new framework for leasing was in process to reconcile tax incentives with international standards, and to design an improved accounting framework for leasing (which the Accounting Act does not cover). These are more likely to materialize later in 2000 with a new framework, but little has occurred since 1997.

A legal framework was being put in place for mortgage banking, which will allow for the trading of mortgage bonds. However, time is still required to strengthen market mechanisms for credit risk evaluation and collection. This market is expected to show high levels of growth in the coming years.

It is expected that over time, there will be significant growth in most "non-bank" services, and significant cross-ownership among financial services companies. This will require better coordination among the regulatory authorities of the BSC at the technical level to avert systemic risk and the spillover effects of mismanagement, weak audit and accounting standards, and other forms of potential misrepresentation among non-banks that could adversely impact banks and public confidence. **Score: 3**

- There were 781 *cooperative banks*[181] at end-1999, down from 1,295 as recently as 1997 and 1,653 in 1993. Thus, the cooperative banking sector has experienced considerable consolidation over the years, and their financial condition appears to have stabilized. Total assets, loans, deposits and capital account for about 4-5 percent of the total banking system. However, regional and affiliating banks showed cumulative losses of PLN 600 million, and there are questions about additional costs to the system imposed by the cooperative banking sector. These issues include the cost of forbearance via the BGF assistance fund and assistance provided to BGZ, the costs of supervision[182], and the potential for systemic risk. The systemic risk issues appear to have been contained. However, it is currently unclear when support to this sector will abate. Agriculture represents the most contentious issue

[181] These banks are remnants of the BGZ system set up to finance and provide safekeeping services for the agriculture sector and rural populations.
[182] One of GINB's five departments focuses exclusively on the cooperative banks.

	between Poland and the EU, and continued support through the cooperative banking system may be a function of these larger issues. However, on a more positive note, the expansion of banks and other financial services companies into retail operations and consumer lending may ultimately make the transition to a purely market-based approach less problematic in the coming years.
•	New legislation regulating *mortgage credit institutions* and the issuance of mortgage bonds was passed in August 1997, although there is limited mortgage activity. Housing loans were valued at PLN 11.6 billion at end 1999, of which about half were to individuals and half were to the corporate sector. About one third of the total stock of loans is old, dating back to 1965. However, this area represents another illustration of increased lending to the household sector.
•	Poland established a *credit union movement* in the early 1990s with substantial donor backing[183]. From a modest start in 1991, membership had grown from 14,137 in 1992 with 13 branches to 324,283 by first quarter 2000 with 467 branches. By first quarter 2000, assets were nearly PLN 1 billion, savings were PLN 780 million, and loans were PLN 690 million. While a small fraction of banking sector figures, the credit union movement has been effective in providing financial services to many people who could not access fundamental banking services until recently. In the future, credit unions may serve as a substitute for cooperative banks, and a supplement to commercial banks. In addition to basic savings and credit functions, the credit unions also provide insurance and brokerage products.
•	*Capital markets activity* in Poland has focused on the Warsaw Stock Exchange (WSE), which has been active since 1991 under the new market-based framework. Market capitalization was estimated to be about PLN 123.4 billion (about $31 billion, or 20 percent of GDP) at end 1999, up from PLN 72 billion (about $20 billion, or about 13 percent of GDP. This represents significant appreciation in the last year, and is nominally about a threefold increase in capitalization since 1997. Growth has come from additional listings, expansion of the market to include parallel and free market trading, and the recent emergence of pension fund activity over the last several months. In June 2000, Poland had 226 companies listed. This compares with end 1999 at 221 companies, 198 at end 1998, 83 at end 1996, and only 16 in 1992. Thus, WSE has shown rapid and steady growth, with the expectation that this trend will continue despite the slowdown in the first half of 2000. Moreover, recent pension reform has invigorated institutional investment, with significant participation by banks and insurance companies. This partly compensates for the limited investment activity of mutual funds, which account for a relatively small fraction of investment on the exchange. Poles appear to be placing more of their savings in bank term deposits and pension fund accounts. The main exchange accounted for about half the companies and virtually all of the market capitalization at end 1999. The main exchange had 119 companies listed, with market capitalization at PLN 117 billion. While the number of companies changed little (from 117 at end 1998), 1999 was a year in which prices rebounded, with the capitalization of these firms rising 72 percent against poor results in 1998. A parallel market for smaller companies was established in the early 1990s with easier listing requirements than companies on the main exchange. This market had

[183] USAID provided financing for technical assistance to the National Association of Cooperative Savings and Credit Unions.

61 companies listed, and market capitalization of PLN 2.9 billion. The free market, established in 1997, included 26 companies and capitalization of PLN 1.3 billion at end 1999. Listings include the 15 National Investment Funds which were listed in June 1997 and are responsible for managing about 512 companies that were "mass privatized." The NIFs have not fared very well, with values declining 7.6 percent in 1999 when the other WSE indicators generally showed more than 40 percent increases during the same period. This may represent a risk, as NIF-related trading companies have become prominent in recent years[184]. Poland has generated large foreign inflows on a per capita basis over the last few years after poor performance in the early 1990s. Foreign direct investment (FDI) began to increase in 1996, and portfolio flows have accounted for a significant share of WSE volume/value since the early 1990s. Privatization of major blue chips has served as a catalyst for this trend. WSE is considered a highly liquid market (based on high turnover ratios), albeit small. Investors are free to transfer capital and earnings in and out of the country as long as tax obligations are complied with. The liberalization of current transactions, a function of OECD membership, assisted in these developments. As of end 1999, there were more than 96 emerging market funds, 14 investment banks and advisers[185], 37 bank-owned and other brokerages, and 15 national investment funds[186]. The number of emerging market funds has shown considerable growth since 1997, and explains some of the portfolio money that has flowed into Poland. The number of venture capital funds had grown to at least 21 by end 1999, as compared with 12 in 1997. WSE has long been heavily weighted towards banks in terms of value, and the banking sector is the second largest sector in value and (and highest in turnover) on the exchange, even though major recent privatizations in the non-bank field have shifted the balance a bit to telecommunications and IT. Bank stocks accounted for about 28 percent of total equity market value at end 1999, as compared with 33 percent of WSE market value at end 1996. Major equities in the banking sector included Pekao SA (#4, at 6.6 percent), BIG-BG (#6, at 5.3 percent), Handlowy (#7, at 4.0 percent), BRE (#9, at 2.9 percent), PBK (#12, at 2.4 percent), WBK (#15, at 1.9 percent), and Kredyt Bank (#16, at 1.8 percent). Thus, seven of the 20 most valuable stocks on WSE are in the banking sector. Other leading sectors on the WSE were telecommunications and IT (35 percent), chemicals (11 percent) and metals (6 percent)[187].

- In addition to WSE, there is also the CeTO, or over-the-counter market for companies that do not meet the size requirements of the WSE. Minimum requirements for CeTO pertain more to share registration and information disclosure based on regulations. This market is geared to accommodate SMEs, particularly those that are generating positive cash flow but are unable to obtain the levels of financing needed for major investments. After an initial spurt of growth, CeTO has found it difficult to attract new listings. By end 1999, there were about 34 companies listed on CeTO. This is compared with 25 companies listed and capitalization of $400 million in early 1998. Daily trading exceeded PLN 1 billion in early 1998. Part of the reason for CeTOs slowdown in activity is due to the rising number of companies that have listed on the WSE parallel and free markets. Combined, these two markets experienced growth of listings from 32 at end 1997 to 87 at end 1999. Market capitalization at end 1999 for

[184] See Aggestan, M. and K. Stobinska, "Development of Capital Groups in Poland", Swedish Network for European Studies in Economics and Business, June 1999.

[185] See Book of Lists: 2000, Warsaw Business Journal.

[186] See Fact Book: 2000, Warsaw Stock Exchange.

[187] See Fact Book: 2000, Warsaw Stock Exchange.

the WSE parallel and free markets was PLN 4.2 billion (about $1 billion), about where CeTO was planning to be at this juncture based on earlier growth through 1997.

- In 1997, Poland passed three *pension reform* bills. One of the bills transformed the pay-as-you-go pension system to a system that is more in line with the three-pillar schemes being developed in the region[188]. This legislation made possible the introduction of a second pillar to the pension fund scheme—mandatory contributions to regulated but private pension funds—to go along with the first and third pillars (mandatory contributions to state funds, and voluntary contributions to private funds, respectively)[189]. In anticipation of these changes, there were more than 19 private *pension funds* established by mid-1999, with more than 5,145,000 members[190]. By end 1999, there were 21 pension funds licensed to manage mandatory private schemes (second pillar), with more than 9.6 million members. Thus, interest in private savings has skyrocketed with the introduction of pension reform. While some banks are involved in the pension fund market—PKO BP and Bank Handlowy, PBK, BIG Bank, Pocztowo-Bankowe (with Paribas), Pekao SA, and Citibank (with Warta)—life insurance companies appear to have the largest market share. In terms of market share, Commercial Union (15.6 percent), PZU-SA (13.7 percent), and Nationale Nederlanden (10.7 percent) accounted for about 40 percent of the market by end July 1999, and were forecasting that their shares would rise to 50 percent by end 1999. Among these three, Commercial Union works closely with BPH and WBK, while N-N is part of the ING Group. Most have Big 5 auditors, and use major banks as custodians—in this regard, BRE appears to have captured a strong niche position in providing custodial services to these funds. Most investments are in bonds, with portfolio mixes showing 75-95 percent on average. By end July 1999, pension funds employed sales staff of 225,000, and there were more than 16,000 outlets around the country[191], making it more of a convenient retail option. Meanwhile, all contributions are required to run electronically through the payments system. This is serving as a catalyst for retail banking development. The new pension system will benefit from the proceeds of privatization transactions. Over time, these approaches combined with changes already made in the indexation system are expected to generate significant fiscal savings by reducing transfers from the budget for social insurance and labor funds. By end 1999, there were signs that momentum was increasing in contributions to open-ended pension funds, and that these combined fiscal and pension reforms were going to serve as a catalyst for capital markets development. While the amount of assets held was estimated at only PLN 2 billion at year end 1999, the amount invested in the capital markets is projected to increase to PLN 4.5 billion in 2000[192]. By end May 2000, pension assets had increased to PLN 5.2 billion, of which more than 28 percent was invested in equities. While still a small fraction of capital markets activity, pension funds are expected to evolve as major institutional investors in the coming years.

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188 See *The Act on Organization and Functioning of Pension Funds of 28 August 1997*.

189 Key requirements include: minimum capital of Euro 4 million; limits on cross-holdings; prudent standards of governance and management; independent supervision; and prudent investment guidelines which limit investments to risk-free securities in Poland and OECD countries, bank deposits and securities, liquid and quoted shares on WSE, investment certificates in investment funds, traded and fully-secured local government securities and bonds, bank-guaranteed domestic bonds, and in foreign bonds and equities issued by firms registered in OECD countries and traded on the main markets of the OECD countries.

190 These data are sourced from The Book of Lists: 2000, *Warsaw Business Journal*.

191 Handlowy and Pocztowo each claimed more than 7,000.

192 See “NBP Report on Inflation: 1999”.

- There is a growing *insurance* sector in Poland. There are now 63 active insurance companies, up from 55 in 1998. Insurance premiums approximated $4.7 billion in 1999, up from $3 billion in 1996-98 figures and more than double the premiums in 1994 (when premiums were $1.8 billion)[193]. Thus, there has been a clear trend in terms of premium income growth, absolutely as well as in terms of GDP. Shares of gross premiums[194] continued to grow in the life sector (from 34.5 to 38 percent) in 1999, while most other classes of insurance stayed at about the same share. Motor insurance remains the largest, although its overall share declined from 46 to 42 percent of total premiums in 1999. The third largest category, property insurance, declined from 11 to 10 percent of total gross premiums in 1999. More recently, it appears that there have been two trends—revenue growth in the life sector, but greater profitability in the non-life sector. There has been greater growth in life insurance from the revenue side, reflecting rising levels of savings among higher income earners given a broader range of instruments from which to choose suitable plans. Moreover, this is a corollary to recognition of the need for private long-term savings as a supplement to the pension system. Life insurance revenues were PLN 6.9 billion in 1999 (about $1.7 billion, or 1.1 percent of GDP), as compared with 1998 figures of PLN 5.2 billion ($1.5 billion, or 1 percent of GDP). Profits were PLN 175 million. Thus, growth has not been major, but the trend is in place. However, while non-life revenues increased at a lower rate, they generated significantly greater earnings. Non-life revenues increased to PLN 11.5 billion (about $2.9 billion, or 2 percent of GDP) in 1999 from PLN 6.6 billion (about the same in dollars and GDP) in 1998. Non-life profits were PLN 342 million in 1999, up from a profit of PLN 64 million in 1998. In life, profits declined from PLN 194 million in 1998 to PLN 155 million in 1999. One caveat to these figures is that they are unaudited, and that many of the claims unpaid may be recalibrated based on international standards of audit for the sector. This would be expected to occur in the non-life sector, where profits may be overstated. Another caveat is that the results do not include Polisa, which failed. Including Polisa results would have diminished sector profitability figures. Major players in the insurance are still PZU, PZU Life and Warta, with about 70 percent of 1999 premiums. This was about 80 percent in 1997, so there is some movement towards competition. This is expected to intensify from 2000 on with the introduction of amended legislation. The key question in the insurance sector has been and is the fate of PZU, which appears to be in the process of privatization (notwithstanding recent political objections to the method of privatization by the Treasury) by Eureko, a consortium of European insurance firms. Meanwhile, as in the banking sector, a strong and growing presence of foreign insurers has added competition to the market. Reforms in the insurance sector will be important to the banking sector, as several banks already have important stakes in life and non-life companies[195]. Further, there are many distribution arrangements in which banks and insurance companies cooperate. It is anticipated

[193] In 1997, total gross premium income was about PLN 12.3 billion ($3.84 billion), or about 2.7 percent of GDP. These figures were up nearly 51 percent from PLN 8.1 billion (about $3 billion), or 2.2 percent of GDP. In 1994, these figures were PLN 4.0 billion ($1.76 billion), or 1.9 percent of GDP.

[194] Statistics have been provided by the State Agency for Insurance Supervision.

[195] Banks' stakes in insurance firms include the following: Bank Handlowy owns a small stake in PZU-Life; PBK-Warsaw owns 20 percent of Warta as well as 100 percent of its own insurance firm; WBK owns 10 percent of Commercial Union; PBG owns nearly 41 percent of Heros non-life and 5 percent of the life company; BISE has a nearly 17 percent stake in TUW; Gdanski has a nearly 11 percent stake in Azur; and ING owns 100 percent of its insurance concern.

	that Poland's banks will intensify their activities in insurance as barriers to universal banking have come down, *bancassurance* offers retail synergies, and incomes and demand are rising. However, more than one bank has found that these benefits do not come automatically, and that a reconsideration of products, markets, and the dedication of personnel has been required after initial market entry. Most firms have "cooperation" agreements with insurance firms in Switzerland and Germany. Poland's amended Insurance Law of 1995 brought the insurance sector closer to EU standards[196]. This has been advanced with the right of foreign insurance companies to sell insurance premiums from their offices in Poland, further intensifying competition in the sector and accelerating openness to foreign investment. However, problems with Polisa in 1999 and two bankruptcies in 1995-96[197] indicate that supervision may be lacking, accounting/audit standards may not be sufficiently stringent, and that regulatory coordination with the securities market may not be well enough coordinated[198]. Low levels of capital and poor risk management contributed to these bankruptcies. Weak accounting and audit standards are also to be blamed. The privatization of PZU is expected to transform the dynamics of the sector, with prime-rated insurance giants showing increasing market share in life and non-life categories over the years.
•	There are at least 72 *leasing companies* operating in Poland[199]. According to the Leasing Companies Conference (the trade association in the industry), the value of leasing agreements concluded in Poland in 1999 stood at around PLN 7.45 billion (net of VAT). This figure is 18 percent higher than the 1998 revenue figure, with particular growth shown in the transport sector. This figure does not include several large companies, which the trade association estimates to have accounted for another PLN 1 billion or more[200]. Thus, leasing revenues (and perhaps including additional and related services such as insurance and freight forwarding) appear to be at least PLN 8.5-9.0 billion. Figures for end 1998[201] show that the net value of leased assets was PLN 5.2 billion, or about $1.5 billion. While not large, it was equivalent to 1 percent of GDP, and is higher than in earlier years. In general, leasing is reported to approximate 8 percent of total investment[202]. Revenues generated from leasing approximated

196 Formulas for solvency margins are in compliance with EU regulations, as are guarantee capital and "own funds" guidelines. Investments are regulated, and insurance companies must notify Poland's independent insurance regulator—the State Office of Insurance Supervision—if it purchases more than 10 percent of the equity capital in a different company, and of any investments in a dependent company. A Guarantee Fund has been established. Upper limits on admissable investments as a percentage of net technical reserves are specified in a manner consistent with EU guidelines. These include up to 100 percent for investments in government securities, up to 100 in bank deposits (but not to exceed 20 percent of the bank's own funds), up to 30 percent in quoted shares, up to 15 percent in non-quoted shares (with a 10 percent limit for individual company shares), up to 15 percent in loans secured by life insurance policies, up to 25 percent for investments in real estate (with a 5 percent maximum per project), and up to 5 percent in bonds and loans for mortgages.

197 These were the Hestja and Gryf companies.

198 The troubled Polisa shares increased 329 percent in December 1999, although it lost more than 63 percent of its value on the year. Much of the problem was associated with accounting techniques, weak audit standards, and a general misrepresentation of the financial condition of the firm.

199 This information is taken from a publication entitled "Leasing in Poland", which appeared as a supplement to the daily newspaper *Rzeczpospolita* on April 25, 2000.

200 The increment of PLN 1 billion seems to be an underestimation, since just one of those companies, Europejski Fundusz Leasingowy, announced that its contracts in 1999 amounted to just over PLN 1 billion.

201 These figures are sourced from the Book of Lists: 2000, *Warsaw Business Journal*, and pertain to only 38 reporting leasing companies.

202 See *Business Central Europe*, November 1999.

PLN 3.4 billion in 1998. These results are partly skewed by the position of LHI Leasing Polen from Germany, which is the largest firm in the market and is based on four large real estate leasing contracts for shopping centers. Apart from this firm, most other leasing companies focus on equipment, machinery and other fixed assets. In addition to leasing revenues, leasing companies also generated total revenues of PLN 4.2 billion in 1998, with the non-leasing portion related to insurance, freight forwarding and other related services. Most leasing companies are small. In total, there were approximately 55,000 leasing contracts (both operating and financial), with the second largest firm—European Fund for Leasing—accounting for about one third of total contracts[203]. There is some market segmentation, as BRE (the third largest leasing firm) tends to finance larger contracts, and MB (the fourth largest) tends to have smaller contracts for vehicle leases.

- *Bank involvement in the leasing market* is direct in terms of ownership and lending. At least 13 of the leasing companies are owned by major banks[204]. Among the banks with ownership stakes in leasing companies are BRE, PKO BP, ING, BIG, BPH, Rabobank, Pekao SA (two leasing companies), Handlowy, Bank Austria-Creditanstalt, Deutsche, Pierwszy Polsko-Amerykanski and Société Générale. In other cases, banks have exposure to leasing companies without having ownership stakes in them.

- As regards recent *trends in the leasing business*, the largest items are vehicles, which primarily comprise heavy goods vehicles (trucks) and delivery vehicles. In 1999, the Russian crisis and the decline in foreign trade produced lower demand for transport services, causing a decrease in this business (and adding to current account deficit problems). Whereas in many other countries passenger cars are a large segment of the business, this is not the case in Poland because of unfavorable tax regulations (see below). This business shrank even further last year to almost negligible proportions. The huge increase in lease finance for other transportation equipment was to an overwhelming degree the result of contracts for railway rolling stock concluded by Polish State Railways. There was also very strong growth in real estate leasing, which has risen in recent years to 22.5 percent of all contracts by value (as against a European average of 16 percent). However, this is chiefly associated with the construction of a limited number of very large office/shopping centers by foreign firms, and the trend may not prove lasting.

- Leasing has not yet fully developed, mainly due to issues related to *tax incentives* and high up-front deposit requirements, although earlier problems associated with collateral appear to be less of a problem. Up until now, there has been no explicit tax framework for leasing. At present, there is not even any standard practice, and different local tax offices have issued contradictory rulings, as have different administrative courts. One of the reasons for this vacuum is legal. There is currently no legally accepted definition of leasing in Poland, or of operating or capital leases, although these terms are freely used in practice. To correct this problem, the Ministry of Finance prepared a draft tax regulation on leasing at the beginning of 1999[205]. However, this has since been shelved, and the Ministry has for the time being

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203 The European Fund for Leasing had 17,401 signed contracts out of a total 54,933 for the market at large.

204 Figures on the leasing market are from The Book of Lists: 2000, Warsaw Business Journal.

205 There is a Government Bill amending the existing Polish Civil Code, which has been submitted to Poland's Parliament for discussion which, if adopted, would provide a definition of leasing contracts (although it does not explicitly use or define the terms "lessor" or "lessee", referring instead to the "financing party" and the "party using

	suspended work on the question[206]. The greatest problems in the area of taxation concern operating leases on passenger cars[207], capital leases on passenger cars[208], and the VAT[209]. In addition to the legal and tax issues, there remains a weak *accounting framework* with regard to leasing due to issues related to valuation. Until these problems are resolved, growth of the leasing sector will be somewhat stifled. Meanwhile, these problems can potentially add to risk in the banking system. First, banks often lend against receivables. These receivables are collateralized by assets. However, the value of those assets is frequently considered to be high for leasing companies to access greater bank funding. Second, some leasing companies are reputed to be undercapitalized or to engage in fraudulent conduct. This can mean being assessed back taxes, which can close them down if the assessment is large or if they are undercapitalized. Meanwhile, this is a risk that a bank may not be aware of prior to lending. While repossession and court procedures are now more favorable than in earlier years and collateral rights have been strengthened for creditors, these procedures can be costly and time-consuming.
•	A handful of *debt collection firms* has been established to work in this field. Most were established in 1992-93, and four of six were set up to collection on debts from abroad. There were at least 10 debt collection companies in Poland in 1997-98, so the field appears to have narrowed in the last two years. However, there may be other smaller firms that operate on a local market basis. There is only one firm that seems to focus on collections in the Polish market—Kaczmarski-Inkasso. This firm had PLN 12 million in revenues in 1998 based on PLN 38.5 million in collections and 17,368 orders based on a success fee of 15 percent[210].

the asset"). The new Civil Code would thus lay down certain criteria to be met by lease contracts, along with the detailed rights and obligations of the parties to such contracts. In previous draft versions of various regulations, an attempt had been made to define leasing contracts as ones where the life of the contract was similar to the useful economic life of the assets being leased. This approach was opposed by the lease finance industry, and provisions of this sort are not included in the current Bill, although the authors of the Bill do not exclude this type of criterion being used for tax/accounting purposes.

206 The draft regulation contained both provisions regarded as positive and negative by the industry. The positive ones particularly related to changing the tax approach to the leasing of passenger cars. The negative provisions included one that taxes payable would depend on the length of the leasing contract, in particular whether it covered at least 40 percent of the normative depreciation period for the asset concerned, or at least five years in the case of real estate (excluding land), and also a provision concerning the minimum price at which the asset could be sold at the end of the contract.

207 At present, there is a limit on the amount of tax-deductible expense associated with company cars. This limit is a multiple of the number of kilometers traveled, and a specified rate in zloty. The resulting limit is so low that it covers at most the cost of fuel and spare parts, but will not cover lease payments. These payments are thus fully taxed.

208 Lease payments cannot be expensed as tax deductible (only interest payments and additional charges can be expensed), although the company concerned can expense depreciation charges. However, even then, the company can only depreciate that portion of the car's value that exceeds Euro 10,000. Also, it cannot reclaim the VAT that is included in the lease payments.

209 There are no clear guidelines on whether VAT is payable in advance on all the installments of the lease, or payable on each installment separately. The Ministry of Finance has sent out circulars saying VAT is payable in advance, although this is apparently in conflict with certain rulings of the Supreme Administrative Court. There is also a conflict between the Supreme Court and the Ministry on VAT in relation to vehicle insurance. Leasing services are subject to 22 percent VAT, but insurance services are exempt from VAT. The Court says that leasing companies can re-invoice their customers for vehicle insurance, but the Ministry says they can not, meaning that customers are effectively paying 22 percent VAT on their vehicle insurance.

210 See the Book of Lists: 2000, *Warsaw Business Journal*.

Thus, average orders are small, approximating PLN 2,317. While this represents an increase in collections from 1996, when five companies reported only PLN 12.6 million in 1996 revenues[211], the low level of aggregate collections suggests this is not a widely used option. Bank Handlowy has a 49 percent ownership stake in one of the firms—Creditreform Polska. Otherwise, banks do not appear to be involved in this market. All together, there are only about 260 employees of debt collection firms, and 25 branches across the country[212]. Differing methods are used, including "pre-legal" and legal procedures, court proceedings, negotiations, mediation, out-of-court reminders, and barter exchange as compensation. Garnishing of accounts does not appear to be practiced in private disputes unless there is a court ruling.

211 The two largest firms, both based in Wroclaw, accounted for virtually all reported revenues in 1996—PLN 11.9 million. These two firms appear to have since merged to become the largest debt collection company in Poland.

212 See the Book of Lists: 2000, *Warsaw Business Journal*.

IV. BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS

The Polish banking system's basic financial indicators—capital adequacy, asset quality, increasing liquidity—have changed little since 1997-98, which is both positive and negative. On the positive side, it reflects underlying stability and measured growth during a period in which there was significant turbulence in emerging markets, and in which international trade was partly set back due to weakness in eastern countries and slower than expected growth in the EU. While there has been an increase in irregular loans, the general trend has been towards a deeper funding base, strengthened capital, significant investment in systems, expansion of meaningful retail banking, marked competitiveness in the corporate lending market, and enhanced management and governance resulting from years of effort, legal and regulatory incentives, and recent strategic investment. All of this has benefited from a disciplined monetary policy that remains focused on reducing inflation and interest rates to EU/EMU standards, notwithstanding recent setbacks.

On the negative side, cost-income ratios are high, net margins are low, assets/GDP and intermediation levels are still relatively low, ROA and ROE have been unimpressive, there remains severe concentration in the deposit market (adding sensitivity and risk in the inter-bank market), and there is continued state ownership in two major banks. However, several negatives have positive components within them. While cost-income ratios are high, some of this reflects investment in systems and training of increasingly well paid personnel, both of which will generate favorable returns in the future.

Intermediation rates are still not at OECD levels, but they have been rising over the years[213]. This trend is expected to intensify in the coming years with more account holders linked to the banking system, banks learning how to better manage credit, and rising incomes creating additional opportunities for both secured and unsecured lending. Lower margins, ROA and ROE reflect high and increasing levels of competition, which is driving banks to improve service levels and to lend more to the SME and household sector. This competition is also reducing the concentration of deposits, particularly as private banks expand their ATM networks and move to "brick and click" approaches to consumer banking.

Even the state/Treasury ownership of PKO BP and, eventually, BGZ will be coming to a close. There have already been preliminary announcements that PKO BP will be privatized through an IPO. This will more than likely lead to a broad giveaway to numerous stakeholders, with management eventually consolidating shares and possibly attracting strategic investment over time. However, it is a step forward, ultimately moving Poland even closer to a fully privately-owned banking sector.

From a supervisory standpoint, NBP/GINB have done a good job in moving Polish banking towards BIS/OECD standards and preparing for EU/EMU entry. Weakness in this domain is in the absence of coordination across financial services (i.e., banking, insurance, securities) at technical levels, notwithstanding coordination that does exist via CBS between banking and securities markets. It is recommended that Poland establish working groups across financial services, and that amendments to laws and regulations focus on integrated, risk-based

[213] For instance, total capital in the Polish banking system at end 1999 was $8 billion, compared with $6 billion in 1997. On a risk-adjusted basis, these figures were $6.5 billion and $5.1 billion, respectively. Assets were about 60 percent of GDP at end 1999, compared with 53 percent of GDP at end 1997. Thus, the figures significantly lag the EU, but the trends are favorable.

supervision on a consolidated basis. Considering the distribution of ownership in the banking system (and other financial services), it would be helpful as well if EU and US regulatory officials would show a willingness to formalize cross-border coordination efforts, although this might be something that could be exercised through BIS. (To date, many of these arrangements have been informal and *ad hoc*.)

Clarification of cross-ownership rights and responsibilities, tougher sanctions against imprudent behavior, and better cross-border coordination are all needed for Poland to properly protect itself against extraordinary financial sector risks that could cause instability, undermine confidence, and weaken implementation of monetary policy. The legal framework also needs to be accompanied by more advanced levels of judicial reform, building on recent improvements in the registration and perfection of liens. Disputes are still time-consuming, costly, and subject to the judgments of some personnel who are not always as skillfully trained in commercial law and practices as needed for a modern market economy.

Overall, Poland's biggest achievements over the last two years appear to have been overcoming fears of competition from large foreign banks, and narrowing the electronic and systems gaps that were fairly wide two years ago. Privatization and strategic investment have been drivers in both these areas. GoP is also to be commended over the last two years in moving forward with key privatizations—Pekao SA, BPH, Zachodni—and providing incentives for modernization and use of electronic transactions.

Poland has generally demonstrated favorable trends in the last several years. Capital adequacy ratios are sound according to BIS guidelines, with the average value of risk-based capital at 13.2 percent at end 1999, and 69 of 77 banks having risk-adjusted capital in excess of 8 percent[214]. Asset quality has been maintained, with only a slight increase in the percentage of irregular loans.

Attention needs to remain focused on the risks associated with consumer lending/installment financing activities, and in third party transactions involving loans and guarantees. As these are the fastest growing areas of activity, there is also a possibility that banks are assuming excess risk due to pressure on margins from other types of lending. The potential for increased levels of default and non-performance in banks' loan portfolios are real risks in the existing environment characterized by higher inflation rates, and the chance that MPC may introduce yet higher interest rates to curtail rising inflation rates. GINB is aware of these potential risks, and banks are required to provision fully for risks in these areas of lending.

Earnings have been relatively weak over the last two years, and on average about half the earnings achieved in 1996-97. Last year's performance of PLN 3.5 billion ($880 million) was better than 1998, but only about two thirds earnings in 1996-97[215].

Funding is still subject to the predominance of deposits, although NBP's reduction of reserve requirements had a net favorable impact on available resources for lending. Recent rate hikes appear to have increased the net spreads for banks by about 100 basis points. Deposit mobilization has improved, partly reflecting the rising real incomes of households, and their interest in some of the term deposits offered by the banking system. Term deposits are now 72 percent of total, up from 70 percent two years ago and perpetuating positive developments in this area. There

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[214] This compares with 12.5 percent at end 1997, and 73 of 81 banks operating at year end 1997 with risk-adjusted capital in excess of 8 percent.

[215] Earnings in 1997 were $1.3 billion after-tax, for ROA of 2 percent. Earnings in 1996 were about the same.

[216] This is a common trend in advanced global markets. However, it puts the onus on companies to comply with stringent securities and listing requirements. The benefit is that financing rates are often cheaper for companies issuing securities than from bank borrowings.

has been a major increase in the number of bank accounts opened in recent years, and public confidence appears high and increasingly favorable. However, there is still significant concentration in the holding of deposits, with three banks accounting for about half of total deposits. This concentration continues to subject the inter-bank market to high levels of sensitivity to the financial condition and liquidity needs of these three banks. Moreover, major deposit-taking institutions not receiving assistance from the BGF (i.e., Pekao SA) are highly sensitive to bank failures, as the current formula for coverage of the net financial loss of a bankruptcy is pro-rated based on shares of deposits held. While this provides an incentive for banks to police other banks, it appears to penalize banks that have been successful in mobilizing deposits irrespective of their own prudence.

The interbank markets function reasonably well, accounting for about 17 percent of total liabilities and capital. However, these markets are still relatively thin and, as noted, subject to the availability of resources from three major deposit-takers. In the absence of a developed corporate bond market, banks continue to draw on syndicated loans for term financing. With consolidation, this should increase over time. However, consolidation may also imperil the availability of resources from banks for large borrowers due to concentration/exposure ratios. Thus, consolidation may also hasten disintermediation, as companies go directly to the markets for future financing if they are unable to access credit from banks[216].

WSE is still heavily weighted towards banks—banks account for 28 percent market capitalization, down from 33 percent in 1997 but up from 21 percent at end 1996—and this provides further incentives for prudent management for performance and growth. Proof has been in the increased strategic investment in banks in the last two years, including the listed banks. However, given narrowing margins in recent years and intensification of competition, there will be temptations to take on high levels of risk. About half of off-balance sheet activities are related to foreign exchange trading. This may be an area in which to focus for risk, as should the high levels of foreign exchange exposure of the corporate sector that remain unhedged. While this may not be a direct risk to banks, major losses by borrowers could ultimately challenge cash flow and the ability of customers to service/repay their obligations.

It is unclear how detailed by currency and maturity the information NBP/GINB have, or the degree to which banks themselves are monitoring for these risks. The larger foreign and listed banks do this as part of their routine risk management. However, it is not clear that NBP/GINB have contingency plans for stress test scenarios in which major institutions' losses could jeopardize financial sector stability. All that is known is that NBP is willing to intervene in foreign exchange markets if there is a risk of instability. In general, boards and management will need to exercise prudence and caution to avert such scenarios. Better MIS and use of these systems, and a strengthening of internal audit capacity *and* autonomy will help in this regard.

Key questions for the Polish banking sector in the coming years will be (i) the pace and method of privatization of PKO BP and BGZ; (ii) the pace of consolidation in financial services, including the impact of these factors in the insurance sector with regard to cross-ownership, securities markets, and other major financial services; (iii) the impact of consolidation on lending to the real sector, with the possibility that at some juncture, fewer and larger banks might not be willing or able to provide enough resources to meet household/SME credit demand without the development of secondary markets or syndications; (iv) the ability to raise capital and intermediation levels to a point needed for competitiveness by global/EU standards; (v) risk management capacity, as bank asset structures grow and take on more and diverse risks under open market conditions that reflect intensified competition; (vi) the sustainability of earnings as banks adjust their risk tolerances and venture into activities in which they have limited albeit growing experience—Polish banks from a product standpoint, and foreign banks from a local market standpoint; (vii) the ability to manage credit risk and absorb losses as banks vie for non-blue chip business, extend credit for longer periods, provide loans with differing interest rate and currency features, and eventually show a larger proportion of unsecured loans; (viii) the willingness of mid-sized Polish companies to adapt to international standards of transparency and disclosure to obtain added financing, particularly as many companies still conceal information from fiscal authorities and their bankers; (ix) the degree to which regulatory authorities will be able to coordinate their supervisory activities in support of safety and soundness, and general financial sector stability, both within Poland and on a cross-border basis; (x) the ability of regulatory authorities to monitor for more "exotic" risks—off-balance sheet items, derivatives—and to contain those risks when adverse effects occur; (xi) the willingness of corporate customers to hedge their risks, and the ability of the market and supervisory authorities to monitor for risks that could cause instability in the markets; and, at some juncture, (xii) the ability of the banking system to weather a downturn in the economy after several years of rapid growth, which might lead to an unmasking of competitive weaknesses in companies that have positive financial results as long as the economy is growing.

Poland has continued to make progress over the last several years as it moves on towards integration with the European Union and plays more of a role in other international organizations (e.g., BIS regional fora, OECD). Poland's significantly greater investment and improved management systems in recent years have strengthened the financial services sector and moved Poland closer to competitive standards. **Score: 3+**

4.1 Capital Adequacy

Poland's banks are adequately capitalized by risk based on BIS standards, with improvement in 1999 after a decline in 1998. Capital adequacy ratios showed a mean value of risk-based capital at 13.2 percent at end 1999, with 69 of 77 banks having risk-adjusted capital in excess of 8 percent. However, many of Poland's private banks remain relatively small in terms of average and total capital—average capital of Poland's private banks was equivalent to Euro 14.9 million[217] at year end, but 8 of those banks had average capital of Euro 31 million. This left a balance of 23 private Polish banks with average capital of Euro 9.3 million, compared to the EU minimum of Euro 5 million. However, in recent years, banks have generally increased their capital. Reaching EU minimum levels was required by NBP/GINB by 1999.

Total capital in banks was PLN 31 billion at end 1999, or about $8 billion. This compares with PLN 21 billion at end 1997, or about $6 billion. On a risk-adjusted basis, banking system capital was PLN 25.8 billion, or about $6.5 billion, as compared with PLN 17.9 billion, or $5.1 billion, at end 1997. Netting out cooperative banks from the total, this amounts to about $80 million per bank at end 1999, compared with $60 million per bank at end 1997. According to NBP, 55 banks had risk-based capital ratios in excess of 12 percent, and 69 were at or above 8 percent. Only eight banks were below 8 percent, although five had negative net capital on a risk-adjusted basis. These and three others are presumably implementing corrective actions.

Capital ratios increased notwithstanding the reduced share of government securities

[217] Year end 1999 capital for private banks in year end Euro at PLN 4.22:Euro 1.

investments (with zero risk weights). For listed banks, WSE share prices remain attractive and the market is liquid, thus providing capital strength and needed financing[218]. Thus, capital for the sector appears adequate. However, many of the private Polish banks and five of the seven Treasury-owned banks are small and will not likely be able to compete without mergers with other institutions. In some cases, this may not be needed as several licensed banks are actually auto finance companies[219]. However, there are many smaller Polish banks that seem unlikely to survive competition with low levels of aggregate capital and aggressive competition for retail markets.

Moving forward, privatization of PKO BP and BGZ are likely to be carried out through IPOs on the WSE (and possibly other exchanges) rather than through strategic sales. Incremental capital may be brought into the system as portfolio money may be invested in these banks through the Exchange. However, for now, it looks as if incremental capital would only come from new purchases (e.g., Deutsche Bank pursuing another Polish bank), increased investment from foreign banks that wish to increase their stakes, and retained earnings.

High levels of capital adequacy will require that (i) assets be properly managed, (ii) banks expand earnings from off balance sheet activities, (iii) investments generate higher returns than in recent years, (iv) high cost-income ratios come down, (v) non-bank activities do not generate harmful losses to the consolidated operation, and (vi) earnings are ploughed back into the banks' operations so as to build critical mass. As of end 1999, CARs were satisfactory. **Score: 3**

- Poland's methodology for calculating *capital adequacy ratios* as well as capital targets has been consistent with EU and Basle standards. Changes were introduced in 1993 after the magnitude of loan losses was uncovered in many of the larger public banks, and the degree to which this distorted earnings and capital. Since then, NBP/GINB have strictly enforced these measures as part of their regulatory oversight function of the banks—through regular reports, off-site surveillance, and on-site inspections. In addition to NBP/GINB oversight, all public and listed banks are required to have annual external audits conducted according to IAS. The findings of the auditors are presented to NBP. Most of the foreign-controlled banks have annual audits according to IAS as a matter of routine, as well as well-developed internal audit functions and regular reporting to boards. Recent troubles with Staropolski may lead to a toughening of audit standards to avoid a recurrence. Poland's listed banks have their capital positions well scrutinized by the market on an ongoing basis, as do many of the foreign banks in international capital markets. These banks have also generally been rated by major rating agencies. Thus, the market is playing a role in the capital and share value of these institutions. However, Poland has 22 majority Polish banks that are not publicly traded. Here, it is incumbent on GINB to maintain constant surveillance of activities that could undermine these institutions' solvency. As of end 1999, there were only eight banks below 8 percent CAR, although five were technically insolvent. System-wide risk-adjusted capital figures at end 1999 were higher than at end 1997, which is particularly favorable given that lending has increased and been accompanied by an increase in irregular loans, and foreign exchange trading has also increased. What is uncertain is if capital figures adequately account for all the off-balance sheet risks banks have, as well as the underlying credit risk associated on exposures

[218] Bank stocks accounted for 28 percent of market capitalization at end 1999. Moreover, there were high levels of turnover at 31 percent. Thus, the market for bank stocks was liquid. However, price-earning ratios on bank shares were 13.9 percent in 1999, about half for the total market. See Fact Book 2000, WSE.

[219] According to NBP, Fiat, Volkswagen, Ford, Opel, and Daimler Chrysler all have "banks". Renault utilizes a financing program through Bank Slaski (see *Polish Business News*, June 2000).

to corporates whose financial condition could be weakened at some juncture by unhedged positions, or the activities of non-bank affiliates. As of end 1999, most banks are generally considered to be satisfactory on a capital adequacy basis.

- Poland had been erratic in its approach to *foreign ownership* in the banking sector[220], although conditions have very much opened up since 1998. In general, FDI has helped power much of the needed investment in industry and services. Banking and other financial services are examples of this, with major privatizations and incremental investment resulting from strategic investors over the last two years. Foreign ownership now accounts for about half of balance sheet figures, as compared with only 13-18 percent of net assets, loans to the non-financial sector, and deposits, and about a quarter of core capital at end 1997. Moreover, while foreign-controlled banks are small compared to their global operations, they have shown far more inclination to invest in their operations and to take on balance sheet risk since 1998. Thus, contrary to the earlier period when they were risk-averse and focused primarily on fee income or a narrow range of corporate customers, foreign banks today are aggressive in all lines of business and are dedicating resources to implement their commitments to the Polish marketplace. Among Poland's 10 largest banks, seven are now owned by foreign strategic investors (or in the process)[221].

4.2. Asset Quality

Asset quality appears to be satisfactory, as evidenced by the favorable share prices of listed banks, the high level of investment into the sector, improving risk management systems at the banks, better governance and management (partly based on regulatory signals and incentives), and high levels of real economic growth since 1994. However, irregular loans have increased in the last two years, reflecting additional risks that banks have taken on to increase margins.

There are lingering questions about underlying quality of assets in the event of an economic downturn, and of the possible misrepresentation of asset values and portfolio performance in some of the smaller banks that may not be employing adequately trained audit firms. Some of the risks include assets that are overvalued due to generous assumptions regarding collateral or real estate values, incomplete reporting of related-party transactions, exchange rate risk associated with some assets/exposures, and unhedged positions in the corporate sector that could jeopardize bank portfolio quality should there be unfavorable movements. In terms of assets, some of the lending provided by banks is secured by intermediaries' receivables that are themselves secured by assets. Such asset values, as well as recovery rates on receivables, could decline in the event of an economic downturn. Likewise, fixed assets are often more of a

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220 Initially, bank licenses were issued liberally to domestic and foreign applicants as the system was transformed from a monobank system to a two-tier system. As elsewhere, low entry requirements in the absence of supervisory capacity ushered in a host of problems—among them mismanagement and fraud—which led to a period of restructuring and retrenchment. During this latter period, from 1992-95, NBP followed an unofficial licensing policy that attempted to steer foreign banks towards existing Polish banks. This led to limited foreign investment. Since 1995-96, the market has again begun to open up to strategic investors, particularly since 1998.

221 These banks are Pekao SA, Handlowy, PBK, BPH, Slaski, Kredyt, and BRE.

headache as collateral than basic inventories on simpler operations, as found in exposures to the leasing market[222].

Relatively weak ROA over the last two years also points to issues that touch on vulnerabilities in both earnings and assets. Loan portfolios to enterprises and households account for 44 percent of assets (end 1999), up from 40 percent two years earlier. Incremental growth in bank assets since 1995 has been from new lending flows[223]. This has proceeded steadily as inflation rates have come down, fiscal deficit financing needs have diminished, net spreads on securities have decreased (justifying the risk of increased lending), and banks have become more comfortable lending to consumers.

Throughout the system, the trend towards increasing consumer loans needs to be monitored, both in terms of underlying quality as well as off-balance sheet risk in the event of an economic downturn. There are asset-based and pricing-related risks for banks to be mindful of, as well as broader market risks. In some cases, the source of funding for these loans is thought to be foreign currency-denominated, which is then lent in zloty at higher rates. Thus, there may be some exchange rate and interest rate risk associated with such lending patterns, particularly if exposures are unhedged (particularly given the recent shift to a fully floating exchange rate).

NBP/GINB has been aware of foreign currency risks over the last few years, and provisioning requirements are strict in this area for banks. However, published NBP reports do not break down foreign currency exposures on a weighted time-to-maturity basis[224]. Poland's comparatively high interest rate environment also presents risks to underlying asset quality, even though interest rates have come down over the years. In the past, asset quality was bolstered by the limited term exposure of most portfolios, and prudent matching of assets and liabilities. However, these risks are likely to increase over time as the real sector seeks long-term loans.

Risks to identify could come in the form of fixed vs. variable loans, or imprudent maturities relative to funding. The mix of exchange rate and interest rate risks will need to get attention given the fully free floating exchange rate and liberalized capital controls. The recent rise in inflation rates and interest rates illustrate these risks need to be actively managed and anticipated. NBP is thought to be fully mindful of these risks from a monetary standpoint, and GINB is aware of these risks from an institutional perspective. In both cases, there is a clear understanding of the link between tighter monetary policy, higher interest rates, the risk of default on debt obligations at the firm level, and the impact this would have on asset quality and earnings in the banking sector. These are clear topics for coordination at technical levels via CBS between GINB and the Securities Commission.

Otherwise, government securities still represent a significant portion of the balance

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222 The leasing trade association estimates that in the industry as a whole (not just the 72 companies for which figures are given), leasing of goods vehicles accounted for 51 percent of all non-real estate contracts. However, the drop in foreign trade, particularly exports, engendered by the Russian crisis in 1997-98, hit the road haulage industry hard. Many trucking firms either failed, or at least found liquidity very much squeezed, and backed out of their leasing agreements. The leasing companies were often unable to sell the vehicles that had been leased at their carrying value on the books, thus taking losses.

223 Loan portfolios were largely cleaned up at the commercial banks in 1993-94, although there are still doubts about portfolio quality at PKO BP and BGZ. There are also concerns about new lending flows in relatively new areas of credit exposure that affect these and other banks, such as leasing.

224 This information would be useful in measuring open positions and how they relate to exchange rate and interest rate risk with regard to loan quality. Banks presumably have systems in place to properly monitor these risks. However, considering that GINB has identified internal controls and internal audit as weaknesses in some banks, there is a risk that some of these banks are engaging in transactions that might not be prudent or consistent with the intent of the legal/regulatory framework.

sheet—24.5 percent of total assets—net of what is owed by the central bank as part of reserve requirements. Lending to the interbank market is considered safe, accounting for about 16 percent of assets. Fixed and other assets represent 15 percent of total. About 8 percent of assets are held at the NBP in the form of cash and securities. Thus, the main underlying questions regarding asset quality are (i) risks associated with the loan portfolio, particularly consumer loans and associated interest rate and exchange rate risks, as well as guarantees, collateral and other off-balance sheet items associated with lending; (ii) the safety of interbank lending; (iii) the quality of investments in non-government securities; and (iv) the quality of fixed and other assets. **Score: 3/3+**
• Poland's laws and regulations address *large exposures, connected/related party/insider lending, nonperforming loans, interest accruals, provisioning, and exposure limits*. These are basically consistent with Basle and EU guidelines. Large exposures and risks are consolidated to include credit, securities and other potential risks. However, there are problems with regard to non-bank affiliates and the potential for connected lending by banks to enterprises that may not have a direct investment in the bank, but may influence or control lending decisions.
• There is favorable *tax treatment for loan loss provisioning*. Specific provisions are generally treated as pre-tax expenses, although general provisions are not. These practices are consistent with BIS recommendations. Current regulations require that banks provision against classified loans as follows: (i) substandard loans at 20 percent (after 30 days); (ii) doubtful loans 50 percent (after 90 days); and (iii) loss loans at 100 percent (after 180 days). Provisioning expenses have increased significantly in recent years. Net movements were PLN 2.6 billion in 1999, and PLN 2.5 billion in 1998, equivalent to about 3.6 percent of total income during the period. The overall portfolio of the banking system is considered reasonably strong, and adequately provisioned today relative to potential risks.
• The share of *irregular loans* for the banking system as a whole was 12.9 percent, a fairly sizable jump from 10.5 percent at end 1998. However, this compares favorably with 31 percent at end 1993 and 20 percent as recently as the end of 1995. GINB has been diligent in providing banks with a basis and rationale for provisioning aggressively, and many banks now recognize the prudence of such approaches. This is a difference from prevailing views two years ago, notwithstanding higher charges in an environment in which margins have declined. Of the end 1999 irregular loans, 4.6 percent were recognized as loss, compared with 5.2 percent at end 1997. Thus, there has been a favorable shift in the mix of irregular loans. Substandard loans were 5 percent of the 12.9 percent total of irregular loans in 1999[225]. Likewise, on a risk-adjusted basis, banks are considered by NBP to be adequately capitalized, with 69 of 77 banks exceeding the BIS-recommended minimum of 8 percent. Median capital on a risk-adjusted basis was 16.6 percent, down slightly from 16.9 percent from 1997. Mean capital was 13.2 percent at end 1999, compared with 12.5 percent at end 1997.

4.3 Management
Bank management was improving in Poland in 1997, and intensified competition and

225 In 1997, irregular loans were 10.2 percent of total, of which 3.8 percent were sub-standard.

strategic investment have perpetuated this trend. Investment in information, systems and personnel in recent years has helped with the level of professionalism in bank management. However, in some cases, boards are apparently composed of people lacking in qualifications suited to governance responsibilities. Weaknesses of the internal audit function and internal controls are also reported to be a problem in some banks.

In terms of management, the high staffing levels appear to reflect weaknesses at many banks at the middle management level due to job protection. As an example, UniCredito agreed to retain high levels of staffing for a period of two years as a condition of its acquisition of Pekao SA. However, this is more than a numbers issue, as overall employment in financial services has grown. The key issue is the efficiency of personnel and their skills suitability under competitive conditions. Personnel expenses have risen at the banks for several years, partly driven by rising compensation and partly by (re)training. However, in some banks, mid-level managers have been protected, and this represents a cost to those institutions that undermines their competitiveness and efficiency.

Banks have utilized information generated for NBP/GINB as part of their larger effort to strengthen MIS and to develop better risk management systems. Management of credit appears to be satisfactory and prudent, notwithstanding the rise in irregular loans over the last two years. However, questions remain about off-balance sheet exposures and risks taken in foreign exchange markets, the quality of collateral, and the potential impact of an economic downturn on portfolio quality. Banks with exposure to Russia were hurt in 1998. Since then, banks have been under pressure to strengthen internal systems and to better monitor exposures and associated risks. This is particularly important with regard to consumer lending due to fast growth in this market.

Corporate exposures to the real sector also need better management, as the share of irregular loans in this category increased significantly in 1999 to 15.4 percent, as compared with 11.9 percent at end 1998. Given that 1999 was a better year for Polish banks, these irregulars may reflect worsening cash flow in the corporate sector. For banks, this is of critical importance because corporates accounted for 77 percent of total claims of banks on loans to companies and individuals, and 89 percent of total irregular loans. In particular, figures in 1999 indicate that these problems were more severe for majority Polish banks in both zloty and foreign currency loans. Foreign banks also showed a rising trend of irregular loans made in foreign currency, although zloty loans showed improvement in quality[226]. The ability to manage these risks will go a long way in determining the future course of earnings, growth and stability in the banking sector, particularly at the largest banks.

Liquidity management appears adequate, as most banks appear to follow prudent asset-liability management practices. However, as shown in the decline in quality on foreign currency loans in 1999, banks may need to strengthen capacity to manage exchange rate risk. This is all the more important as Poland has moved to a fully free floating exchange rate, and as banks are showing growth in off-balance sheet foreign exchange trading.

Meanwhile, banks may also have to strengthen their capacity to manage interest rate risk, as MPC has demonstrated its willingness to hike rates significantly to control inflation. The influx

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[226] According to NBP, majority Polish banks saw irregular loans increase from 10.6 percent in 1998 to 13.9 percent at end 1999. Irregular zloty loans increased from 11.5 percent to 14.2 percent. Irregular foreign currency loans increased from 7.2 percent at end 1998 to 12.4 percent at end 1999. Majority foreign banks saw irregular loans increase from 11.4 percent in 1998 to 13.0 percent at end 1999. Irregular zloty loans decreased from 13.0 percent to 12.7 percent. However, irregular foreign currency loans increased from 7.7 percent at end 1998 to 13.7 percent at end 1999

of portfolio funds, and the potential for a rapid withdrawal, also adds to both interest rate and exchange rate risk for banks that will need to be managed. Weaknesses in the management of exchange rate, interest rate and pricing risk may surface as banks search for ways to increase earnings under more competitive market conditions. Banks, investors in banks, and NBP/GINB will need to monitor these risks to avoid unanticipated losses that could impair capital. Coordination with the Securities Commission is of vital importance in this domain, as banks account for nearly 30 percent of WSE market capitalization and turnover.

To date, Polish banks have generally followed conservative practices to avoid the transactions costs of increased hedging risks. Banks may be willing to incur these costs in the future, and if so, they and those responsible for oversight will need to be certain that hedging strategies are prudent and do not subject the banks/financial sector to dangerous risks.

Banks have been investing in systems and personnel in recent years to ensure they have suitable risk management systems in place. Strategic investment in many banks has helped in the last two years. **Score: 3+**

- Many of the key issues facing banks from 2000 on are similar to those faced in 1998. They essentially relate (i) to the ability to generate improved earnings in a more competitive and consolidated banking environment in which pressure on margins is increasing, (ii) to manage risks sufficiently to sustain confidence and growth in the banking sector, (iii) to retain adequate and higher levels of capital, (iv) to develop other sources of income in addition to managing traditional balance sheet risks, including eventual movement towards unsecured loans, (v) to adapt to changing liquidity rules, where banks will eventually be net borrowers from NBP rather than lenders, (vi) improving funding sources to create a more stable base for operations, (vii) attracting and retaining needed personnel as the sector becomes more complex, and (viii) playing a watchdog role of their peers and competitors in support of underlying stability. *Fundamental banking system risks* include underlying credit quality and collateral values, and to the availability of sufficient quantities of credit to meet real sector demand. The former relates to individual loans. The latter relates to the possibility that consolidation might also reduce the number of potential institutions that will co-finance large credits, or participate in loan syndications. This could be a problem for SMEs if administrative costs do not justify making smaller loans. This risk might also push larger firms to institutional investors and the markets for debt and equity financing. If so, this kind of disintermediation may be helpful to financial sector stability, reducing the sensitivity of banks to large credit exposures that might fail. In future years as customers demand unsecured loans, banks will have to more fully develop capacity to manage cash flow lending. This will include the character of the individuals to whom the banks are lending. As noted above, credit exposures will entail exchange rate risk, interest rate risk, and in commodity-oriented exposures, pricing risk. (The absence of repricing data on reporting forms to GINB is acknowledged as a supervisory weakness.) Hedging costs will go up, but over time this will also provide insurance against risks, and pricing will reflect gradual maturation of this business. Other balance sheet risks are bound to be linked to exposures in leasing, syndications of consumer loan portfolios, movement towards securitization based on loan portfolios, and housing finance as this business grows in future years. Off-balance sheet contingencies that relate to trade finance, foreign exchange exposures, and third-party guarantees will need to managed.

- *Tools and practices for effective risk management* are well known by the banks. The challenge is implementation, which will be assisted by good judgment, reliable information, familiarity with clients, compliance of clients with covenants and agreements, adequate protection and reserves, and up-to-date systems to understand risks associated with more complex products and on portfolios as a whole. Banks will need to play an active and disciplinary role in the market, much as bank regulators/supervisors have imposed requirements on banks for safety, soundness and stability. Minimizing on-balance sheet risks will require sound underwriting standards, effective monitoring of borrower compliance with loan covenants, adequate reporting standards, timely collection on loans, and perfecting liens for adequate collateral. Stress testing for downward movements will be useful for banks to manage the potential losses that could materialize. For syndication and off-balance sheet risks, banks will need to ensure that cash flow is properly estimated so that risk-adjusted discounts/premiums can be applied for the markets to function in an orderly manner, and for banks to protect their capital. These risks have been particularly pertinent in Poland since 1996 as consumer lending and installment finance have increased. Many of Poland's 2.5 million businesses have little or no formal credit history. Efforts through the PBA to develop a credit information bureau will help in managing exposures to the small business sector[227]. Keeping up with changes in ownership and control in the real sector will be important for managing risks on larger enterprise exposures. This is also of critical importance on exposures to individuals, as Poland has experienced significant growth in the number of card holders in recent years. The availability and quality of credit information on individuals and households as well as on enterprises will be helpful to the banks in managing credit risk. Once these risks are better understood and the industry matures, fees will also decline. This has already begun to occur with growing competitiveness at the retail level since 1997-98. Mortgage lending activities will require the development of specialized credit risk management skills, particularly as this kind of lending is long-term in tenor and heavily dependent on securitization and syndication in the markets backed by an effective legal framework for collateral. Thus, banks that enter the mortgage lending market will need to enhance their management of interest rate and pricing risk, monitor changes in the tax code, and monitor movements in secondary and syndicated markets when they develop. There are also likely to be growing risks associated with securities investments, particularly as capital markets activities are linked to more complex and exotic instruments that are sometimes bundled across products and markets. Fraud will need to be monitored as banks increasingly market to high net worth individuals, and as cross-border transactions increase. Later in 2000, GoP is expected to move towards creation of a central inspectorate on money laundering, fraud, and related financial crimes. As universal banking becomes the norm, there will be a risk of connected lending resurfacing. As with Staropolski, regulators and banks will need to be made aware of affiliates, actual control of these affiliates, how financial resources are managed, and how these can adversely impact the banking system and other financial markets. This is doubly important when such affiliates actually own the banks. On these points, it is recommended that Poland provide GINB and CBS with greater supervisory authority and legal power to intervene on a wholly consolidated basis, that the onus be on companies to keep regulators and markets informed in a timely manner, and that violations be severely and swiftly punished. EU Directives may not go far enough in heading off potential financial risks. The importance of cross-border cooperation *and* capacity can not be overstated.

[227] Banks have been doing this in recent years by providing incentives for households and businesses to place term deposits with the banks, using compensating balances, offering higher interest rates, adjusting fees, and structuring exposures to higher income levels.

- As elsewhere around the world, bank boards and management will need to continuously adjust their performance targets based on satisfactory risk tolerances and strategies for achievement. This will depend on sound and timely information, and the ability of boards and management to be able to properly use such information. This will require ongoing development of information systems, autonomous and strengthened internal audit, and modernization of *risk management systems and practices*. Banks have improved their capacity in recent years. Strategic investment has helped in this domain, as have incentives and pressure from NBP/GINB. However, there are apparently still weaknesses in some banks' internal controls. Performance of the internal audit function is considered erratic. The composition of bank boards does not always reflect the specialized skills and insights needed to monitor management performance, or to fully understand and approve strategic plans where complex instruments and activities are involved. However, in general, Poland's largest banks are reported to have satisfactory systems in place for lending, trading and investment activities—maturity, pricing, and currency issues from a portfolio standpoint, as well as the underlying quality of each asset. In the future, there will be times when banks will need to demonstrate their ability to set prudent risk tolerances under changing conditions, and to identify deterioration in lending, investment and real estate portfolios early on to prevent such developments from having a material adverse effect on capital and liquidity. Rising inflation and interest rates, weak margins, unimpressive ROA/ROE figures, introduction of a freely floating exchange rate, and a general increase in competition put the onus on bank management, boards and shareholders to properly manage resources. To increase earnings, banks will have to increase their volume of stable earning assets, and/or increase their willingness to take risk in other activities that carry with it greater upside and downside potential on earnings. As banks consolidate and seek to grow, management of associated risks will be that much more critical to returns, and to general financial sector stability.

4.4 Earnings

After-tax earnings increased in 1999 after a poor year in 1998. However, earnings are lower than in 1996-97. On a dollar basis, after-tax earnings were about $880 million in 1999 against an average $1.5 billion in 1996-97. On a bank-by-bank basis, average profit was about $12 million and ROA was 1 percent, compared with $17 million per bank and 2 percent ROA in 1997.

Earnings have been declining for years due to pressure on margins in the corporate sector, reduced net spreads on investments in government securities, and higher cost ratios. Reduced spreads in the corporate sector are largely due to increasing competition, which is also partly due to the second factor of reduced net spreads from securities investments.

As foreign investment has increased dramatically since 1998, the government's need for bank financing has diminished. This trend had already begun in 1996-97 with economic growth, increased revenue collections, and stabilized levels of deficit financing. Reduced government demand for bank financing led to lower earnings from these investments for banks, prompting banks to seek out new financing activities. With the blue chip market saturated and the banking sector becoming more competitive, banks have shown increasing willingness to lend to the consumer market, mainly for installment financing for vehicles.

Meanwhile, there has been further pressure on earnings due to costs. Cost to income ratios were about 93 percent in 1999, up significantly from 85 percent in 1997 and 81 percent in

1996. Ratios were particularly high at foreign banks (i.e., 95 percent), the assumption here being that UniCredito is investing heavily in Pekao SA, and other foreign banks are tooling up to capture more of the retail market. Private Polish banks' ratios were lower than the public sector banks. In general, cost-income ratios were high due to overhead costs at PKO BP, BGZ and Pekao SA, and higher personnel compensation and provisions at all banks. At the state/Treasury-owned banks and Pekao SA, head count is high, and there are questions about productivity. Majority-owned Polish banks had 86,199 employees at end 1999, as compared with 63,439 at the foreign-owned firms. This reflects a more manual orientation to retail banking among the majority Polish banks, as evidenced in the numbers of branches and other offices—1,243 branches and 6,939 offices at Polish banks, compared with 992 branches and only 1,048 other offices among foreign banks. Given the Pekao SA has about 40,000-45,000 in staff and 700 branches/offices, the other foreign banks appear to be much leaner operations, and far more profitable on a per-employee basis. **Score: 3-**
• *Interest income* for the banking system was PLN 36.5 billion (about $10 billion[228]) in 1999, as compared with 45.2 billion ($14 billion) in 1997. About 63 percent came from lending to companies, 25 percent from securities, and 12 percent from inter-bank loans. An additional PLN 33.2 billion ($9 billion) was generated by *foreign exchange gains, commissions and fees*. However, due to slim margins for lending activities and foreign exchange losses, net income from core operations was only PLN 21.6 billion ($6 billion), about a 6.7 percent return on average assets in 1999[229]. Meanwhile, *general operating costs* are high due to personnel costs and required provisions, bringing net operating income down to PLN 5.7 billion ($1.6 billion). Overall, *after-tax profits* were PLN 3.5 billion ($880 billion), or $12 million per bank after netting out cooperative banks[230].
• The *structure of earnings* reflects movement towards foreign exchange trading, with FX gains, commissions and fees contributing nearly as much to income[231] as lending and securities investment. This is expected to continue in 2000 and beyond, with banks' balance sheets slowly being reconfigured to reflect earnings from a broader range of sources. In prior years, banks generated large net spreads on earnings from GoP securities (relative to deposit costs). More recently, banks have had to adjust to lower inflation and interest rates, although real interest rates remain comparatively high by European standards. In the coming years, it is expected that banks will not be able to leverage off of the public sector's financing needs as much as in the past to generate needed earnings and returns.
• *Interest rates* on loans and deposits are not subject to *controls*, nor are other fees. However, Poland does have consumer protection clauses built into regulations to ensure the market functions in an orderly and competitive manner.
• There is little evidence of *mandated lending* in Poland, although some public banks are reported to be part of some political parties' patronage systems. Most bank lending to loss-

228 As this is a flow figure, the dollar figure is based on an average exchange rate for 1999.

229 "Average assets" = (1998 year end assets + 1999 year end assets)/2.

230 Cooperative banks generated PLN 203 million ($58 million) in 1999, or PLN 260,000 ($74,250) per cooperative bank at end 1999.

231 These categories generated PLN 33.2 billion in income, 91 percent of the interest income figure.

making enterprises was curtailed in 1993. Support for these enterprises is often through the government budget. This has removed most of the pressure from government on banks to lend to the agriculture, coal and steel sectors. In the case of coal, GoP is borrowing from the donor community to restructure this sector. Steel companies have undergone restructuring programs, although their privatization has not yet succeeded. In general, directed lending has been significantly reduced from the early 1990s. Membership in the OECD in 1996 further reduced possibilities of mandated lending.

- There is a 32 percent corporate income *tax rate* that applies to banks, plus additional taxes. The rate will be 30 percent in 2000, and has been reduced from 40 percent in 1996. In 1999, the effective corporate income tax rate for banks was 38 percent in 1999, compared with 32 percent in 1997.

4.5 Liquidity

It is the position of MPC that the banks have excess liquidity. Movement to a freely convertible exchange rate and greater reliance on open market operations is expected to reduce growth in official reserves, and allow a more market-based determination of pricing for banks' borrowings from NBP and the inter-bank market.

Funding is slowly improving in the aggregate due to more bank accounts, and the willingness of households to increase their term deposits. Meanwhile, a decline in reserve requirements provided banks with more resources for lending in 1999. However, structural funding weaknesses remain due to the concentration of deposits in three banks, the thin corporate bond market, and low capital. While term deposits and bank capital increased in 1998-99, it will still take time for Poland to narrow the gap with EU banks in terms of size and intermediation resources.

The inflation rate has been increasing since August 1999, consequently pushing the MPC to raise interest rates twice. This has pushed up rates 450 basis points, although it may also help bank margins.

The secondary markets are still weak for securities, which means banks have to rely on real sector deposits for about 62 percent of overall funding and the interbank market for another 17 percent. Meanwhile, PKO BP, Pekao SA and BGZ account for about half of total deposits. Thus, most other Polish banks have weak funding bases, although the listed banks are able to obtain WSE financing and syndicated loans from abroad. While the interbank market is relatively safe and meets some financing needs, rates showed some volatility during late 1999-2000 when interest rates were being raised.

Bank liquidity is expected to benefit from recent improvements in the payment system. Meanwhile, higher capital among the larger banks and access to banking and capital markets abroad should be able to provide needed financing should deposits, inter-bank sources, and domestic debt issues not cover banks' financing needs. **Score: 3-/3**

- In terms of *funds flows*, banks' funding sources are 62 percent from deposits from the non-financial sector, primarily term deposits from household sources and, to a lesser extent, corporate sources. This is little changed from 60 percent in 1997 and 61 percent in 1998. For

	overnight or short-term needs, there is an interbank market where banks obtained about 16 percent of their funding. Capital contributes another 8-10 percent[232]. Thus, about 80 percent of funding derives from deposits and bank borrowings, with another 10 percent from and capital. With earnings low in 1998-99, most of the incremental funding base has actually come from the additional $1.5 billion in foreign investment into the sector. However, much of this has been absorbed through investment and operations. The easing of reserve requirements helped with incremental lending flows. In terms of uses, about 44 percent of funds are lent to enterprises and individuals, up from 40 percent in 1997-98. Another 17 percent is provided to the interbank market. Most of the balance goes to the government, either in the form of investment in government securities (24.5 percent), cash and reserves held with NBP (5 percent), or direct loans to government (3 percent). There appears to be less crowding out of private investment than in earlier years, as reserve requirements have come down, investment in government securities has come down, and lending to the real sector has increased.
•	Bank management is in a position to manage fundamental *sensitivities to pricing, interest rate, and exchange rate movements*. Prudential regulations are adhered to, and bank managers have had experience over the years with volatility. Recently, two rate hikes increased interest rates by 450 percent. Meanwhile, in March 2000, Poland attracted its highest ever portfolio inflows which, along with continuing FDI, has brought in high levels of foreign exchange into the banking system. Banks have had to strengthen their systems and management skills in recent years, particularly with liberalization of the capital account. General ledgers are now automated at the major banks. NBP previously monitored movements in exchange rates and set interest rates as part of its open market operations and focus on price stability. It is expected that NBP will continue to monitor, although intervention in foreign exchange markets will likely only occur if there is a broader threat to financial sector stability. For supervisory purposes, NBP/GINB might benefit in the future from requiring banks to provide more detailed and disaggregated reporting[233] on a more frequent basis now that systems are more integrated and automated. The current challenge is the widening current account deficit, the impact this could have on both exchange rates and interest rates, and how major changes in these values could impact banks' portfolios. Interest rates increased in late 1999 and then again in early 2000 due to MPC concerns that banks were financing a consumer goods binge. This happened in 1997 as well, and looks set to continue if the inflation rate does not begin to come down. Given such an increase in interest rate and pricing volatility, GINB has acknowledged that the absence of repricing data on loans and deposits in bank reports to NBP/GINB is an informational weakness.
•	*Reserve requirements* are currently a part of mandatory bank deposits held with NBP. (Their use as a tool of monetary policy is discussed in Section 2.3.) The level of overall assets placed with NBP was about 7.5 percent of total assets at end 1999, as compared with 14.4 percent of total assets at end 1998 and 7.3 percent at end 1997. This reflects a dramatic improvement for the banks, and has been reflected in increased levels of lending. Banks receive no

[232] The figure is 9.8 percent if earnings are fully retained, and 8.3 percent if all earnings are paid out as dividends. The real figure is likely closer to 9.0-9.5 percent.

[233] In addition to open positions, NBP might consider types and volumes of transactions by type of currency and amount, any indexation features, maturity, and interest rate features. These could be presented on a weighted and time-to-maturity basis for further testing or sensitization. The onus should be on banks to conduct the testing. However, such reporting could assist NBP with regard to potential systemic risk.

compensation for these reserves. Reserve requirements in effect at end 1997 were 20 percent of zloty demand deposits, 11 percent zloty time deposits, and five percent of foreign currency deposits. By 1999, they had declined to 5 percent on all deposits.

- Banks are generally considered to be in compliance with NBP regulations that limit open exposures in terms of currency, pricing and tenor. The data presented in NBP's evaluation of the financial condition of the banks do not provide sufficient information to make a judgment of the *asset-liability management practices* of the banks. However, zloty exposures are considered to be generally matched, and most exchange rate and interest rate exposure is thought to be prudently or conservatively hedged. This has taken on greater importance with movement to a free floating currency. The main zloty risk is thought to be with maturity mismatches. Regular reports on the term structure of assets and liabilities are presented to NBP from the banks, and supervision is clearly aware of the risks, as are most bank managers. Where there may be a shortcoming to the information presented is in the mix of sensitivities—fixed or variable interest rates, exchange rates, and duration—on a time to maturity basis. In terms of matching, banks are exposed to the household sector. As for loans, the increased lending to individuals and small businesses has narrowed the gap. In prior years, Polish banks mobilized resources and financed government. Today, term depositors are the main creditors to banks, but they also receive a larger share of bank loans. Banks have kept exposure to the financial sector fairly constant. As for the term structure of deposits, about three quarters are term deposits. Loans tend to be short-term, and are almost unanimously less than a year. As for the currency structure of assets and liabilities, there is insufficient information on the asset side, which may reflect a possible reporting weakness. On the liability side, about one-quarter are foreign currency-denominated. However, on the asset side, there is no breakdown from NBP/GINB on exposures on a currency-related basis. If GINB is not aware of these distributions and mixes and has not stress-tested for downside scenarios, one recommendation would be to do so. If GINB is aware, there is little reason not to publish such documentation in its year end reports. There may be risks to currency exposure, as reports to NBP from the banks have traditionally converted values into zloty. With Poland's sensitivity to rapid portfolio movements in and out and a freely floating exchange rate, bank portfolios may be subject to short-term exchange rate risk. Many banks were thought to have inadequate gap analysis when managing their foreign currency exposures two years ago, although it is also now assumed that Polish banks have strengthened capacity in this domain, foreign banks are providing needed expertise where they have invested, and GINB has sent signals to banks that weaknesses in this area need to be corrected. As Poland's performance in international currency markets has been less volatile than other emerging markets, the assumption here is that banks have strengthened their capacity in this domain during a period in which on- and off-balance sheet foreign exchange transactions have increased. However, increased volatility is virtually inevitable with the movement to free float.

4.6 Operating and Regulatory Environment

Poland's banking system enjoys increasingly high levels of public confidence. While intermediation rates may still be lower than in some of the neighboring countries—and well below OECD and EU norms—deposit mobilization has been increasing steadily and in absolute terms, as well as proportionally as a percentage of money supply and GDP.

One indication of growing confidence has been the increasing share of deposits held with banks that are term deposits, a trend that began a few years ago. This partly explains the lack of alternatives for Polish savers, although pension reform and growth of the life insurance market is changing the landscape while banks compete to build their funding bases. These deposits would not be held in banks if there were a lack of confidence in their soundness. Moreover, consumer confidence has been mounting over the years, with favorable views by the public increasing from 25 percent of the population in 1994 to 75 percent in 2000.

Membership in the OECD, financial sector reforms adopted in 1997, the absence of major bank failures (even during the emerging market crisis), and the significant increase in prime-rated foreign investment has helped build that confidence as Poland moves towards membership in the European Union. Concentration has continued to diminish over the years, and the best performing banks are ones listed on the WSE, which are subject to high levels of regulatory and market scrutiny. Thus, market discipline has taken hold, and incentives are increasingly in line with global standards.

There has been increasing investment from the private sector in banking, particularly since 1996. Strategic investment has been prominent since 1998. All of this has been reinforced by the sustained development of effective banking supervision that has provided increasingly effective oversight since the mid-1990s.

Nonetheless, several weaknesses and challenges remain in the operating and regulatory environment for banking. First, there are questions about technical coordination across financial sub-sectors (i.e., banking, securities), and how the CBS would react in a period of banking crisis. While GINB has moved towards risk-based supervision, CBS is not evaluating risks to the banks on a fully consolidated basis. Second, there appear to be weaknesses in coordination at GINB between off-site surveillance and on-site inspection. Third, there appear to be serious weaknesses in neighboring countries' supervisory agencies, making Poland more vulnerable to cross-border risks. Fourth, it has been difficult to monitor affiliates of banks, and to ascertain actual control of resources. Cross-border activities add to the complexity of this challenge. Fifth, GINB is faced with serious personnel challenges in the coming years, as its funding faces potential constraints and employees move on to more attractive compensation schemes in the private sector. Beyond GINB and supervision, while PKO BP and BGZ may no longer be serious supervisory concerns, they are potential vehicles of political patronage, and they continue to draw on assistance funds of the BGF at the expense of the banking system. The Bank Guarantee Fund has been used to assist these banks over the years, distorting the playing field. Meanwhile, the legal framework has gotten better for banks, but judicial obstacles remain as the court process remains slow and costly.

Score: 3+

- Poland introduced a *deposit insurance* scheme in 1994 consistent with EU designs. Until December 1994, no general deposit insurance scheme existed in Poland[234]. New legislation—

[234] Based on the 1989 Banking Act, the state Treasury guarantee was extended to savings deposits only in banks established prior to that date. Thus, only two state banks, BGZ, 1,664 local cooperatives, and 11 joint-stock banks predominantly under Treasury ownership enjoyed a deposit guarantee. This created an uneven competitive environment for new private banks, undermined private banks' incentives to mobilize deposits, weakened their funding bases from the start (particularly private Polish banks, as foreign banks could access funds from external sources), and raised the level of risk presented by private banks to the safety of the banking system at large. While private Polish banks were small, mismanagement and fraud in some of these institutions reinforced the lack of confidence many people had in banks as a whole. This was a particularly sensitive issue after the turbulence of 1989-

the Bank Guarantee Fund Law—provided a framework for more comprehensive deposit insurance, consistent with EU guidelines. The Fund initially guaranteed deposits at banks held by individuals and legal entities up to the equivalent of Euro 5,000. Current coverage is now 100 percent of deposits up to Euro 1,000, and 90 percent coverage from Euro 1,001-11,000. However, there have been problems reported with the administration of the Fund that point to structural weaknesses in the banking system, excess politicization, and a higher-than-justified tax on the banking sector. The Fund is required to entertain requests for assistance from troubled banks. As a result, the Fund provides fairly large long-term loans at preferential rates for troubled institutions. Least-cost methodologies are not employed, adding to "bailout" costs. There is also no sunset provision assigned to the assistance. Banks pay obligatory contributions to the Fund, which then pay the guaranteed portion of the deposits in banks that fail or face such a threat. When a failure exceeds the available resources of the assistance Fund, banks are assessed the difference based on their share of deposits. This penalizes other banks, and serves as a disincentive to mobilize deposits. As this is cash-based, this clearly represents an expensive transfer from stronger to weaker banks. In particular, it penalized Pekao SA and some of the other private banks with comparatively large deposits, while PKO BP and BGZ, state/Treasury-owed banks benefiting from the assistance fund, were exempted from the assessment. Thus, while the existence of a Fund is intended to reinforce confidence in the banking system, the administration of the Fund appears to be working at cross-purposes with the need for efficiency and prudent management standards in the system. At a minimum, there is greater need for financial transparency, more market discipline, and better "consumer-based" assessments of safety and soundness in banks. The open disclosure of monthly income statements and balance sheets based on a standardized framework with details on non-performing assets and other details that reflect individual banks' risks to deposit safety would be a starting point for this effort. These could then be placed in bank lobbies, be made available over the internet, and be published by financial journals/gazettes.
• While Poland did not follow an explicitly expensive bank recapitalization program for its troubled banks, there has been significant cost involved. In terms of fiscal costs, the restructuring of the seven state commercial banks in the early 1990s was estimated to cost about $1 billion based on the up-front recapitalization, as well as the higher net spreads on government securities that were used by the banks to continue to recapitalize from operations. Larger restructuring efforts at PKO BP, BGZ and Pekao SA are more difficult to estimate in terms of cost, although loans extended by BGF approximate PLN 1 billion[235]. This has been partly vindicated by the acquisition of Pekao SA Group by UniCredito of Italy in a PLN 1.5 billion transaction. However, PKO BP and BGZ continue to benefit from forbearance and assistance fund resources for BGF at the expense of other banks. In effect, these activities have sustained a policy of providing resources for *bank rescues*. However, as the financial condition of the two banks has improved, use of *lender of last resort* financing does not appear to be necessary. What will likely be necessary is some kind of financing or concession from government for the housing portfolio of PKO BP, which will add to the bail-out cost of these banks.
• Poland's banking system has become increasingly competitive, as evidenced by the growing

90, when many peoples' zloty savings lost value. The implicit guarantee afforded the public banks reinforced some of this confidence, but such an approach was clearly anti-competitive and inconsistent with EU guidelines.

[235] See Jaworski, W., "A Change Is Needed," Gazeta Bankowa, 6-12 June, 2000.

	private sector share of banking activities and the push into retail banking. The only noticeable category in which *high concentration* is evident is in the deposit category, with PKO BP, Pekao SA and BGZ accounting for about half of total deposits. However, this figure has come down from 56 percent in 1997. The largest share is with PKO BP, with about 26 percent of total banking system deposits, partly due to its large network of about 1,000 branches and agencies around the country. Pekao SA has an additional 21 percent or so of deposits. The market and NBP/GINB will need to monitor the capital and liquidity positions of all three banks to prevent any portfolio deterioration from causing panic in the interbank market. In earlier years, any spread of bad news regarding PKO BP had the potential to cause a run on that bank. This might have had repercussions on the interbank market and could have prompted NBP into lender-of-last-resort intervention. Since the, PKO BP appears to be stronger, and Pekao SA has been acquired by UniCredito. Thus, while concentration exists, the financial condition of these banks appears to have strengthened.
•	Poland has steadily increased the capacity and *effectiveness of banking supervision*. NBP originally focused on developing effective institutional capacity in tandem with the bank restructuring efforts that were pursued through most of the mid-1990s. With the revised banking legislation passed in late 1997, efforts have since focused on risk-based supervision in which banks themselves are increasingly responsible for managing risks as a function of regulatory compliance and monetary/systemic stability. GINB avoided or minimized some of the weaknesses found in other countries—fragmented organizational structure, dispersed authority, absence of coordination, flawed surveillance due to poor information, insufficient funding—and has generally benefited from a growing mandate to ensure that banks accurately report needed information to monitor for compliance with liquidity, solvency and general prudential requirements. GINB has concentrated on moving towards effective implementation of the Core Principles. This has included setting guidelines and standards for banks to introduce comprehensive risk management processes, strengthening internal audit and controls, and establishing better IT/MIS for a host of risks. Since its inception in 1998, the Commission for Banking Supervision has followed a more risk-oriented approach in conjunction with regulators in other financial services (and across borders)[236]. Ongoing challenges and risks to the effectiveness of banking supervision include the changing nature of the financial sector at large, the development of needed MIS, banks' internal controls, back office operations, internal audit functions, continued adverse effects on the system posed by large troubled banks, and inadequate legislation to date to permit effective consolidated supervision as trends indicate movement towards universal banking. According to NBP, one of the major causes of less than total effectiveness of banking supervision is due to weaker than needed supervisory enforcement powers in banking legislation[237]. In particular, this seems to be the case with regard to troubled state-owned banks. More generally, GINB feels it has its autonomy and enforcement mandate undermined by cumbersome administrative procedures that are imposed by law. As found elsewhere, the supervisory mandate would be more effective with the final privatization and/or liquidation of troubled state-owned financial institutions. Notwithstanding the relative autonomy of GINB within the independent NBP, state ownership in large institutions represents continued influence from vested interests through quasi-fiscal mechanisms. This continues to serve as a constraint on full-scale

[236] This approach, which is in keeping with international trends, relies more heavily on the banks themselves adapting their own new systems, procedures and controls to protect the system against undue risks.

[237] See "On-Site Examination Manual", www.nbp.pl.

modernization of banking supervision, not to mention that it is a point of contention in EU negotiations and slows financial sector modernization. In the future, NBP/GINB will be challenged to keep up with the growing sophistication of the banks, particularly as new strategic investment accelerates modernization, and products/strategies reflect greater complexity, speed and cross-border characteristics. Supervision will need to improve in several areas, with particular focus on (i) technical coordination across financial services (i.e., banking, securities), (ii) contingency planning for a banking crisis, (iii) effective consolidated supervision, preferably backed by a legal mandate, (iv) coordination at GINB between off-site surveillance and on-site inspection, (v) coordination with neighboring countries' supervisory agencies, (vi) monitoring affiliates of banks, and determining the control and flow of resources where these pose a serious risk to financial sector stability, and (vii) keeping up with the latest products/services, including complex derivatives and internet banking. All of these challenges will become more difficult due to competition for skilled employees, and more attractive compensation packages in the private sector. Technical improvements may be needed as well for interest rate and exchange rate risk (due to the change to a free floating currency), securitization, large syndications, and third party risks. At a minimum, GINB will need to have specialists who can evaluate sophisticated risk management models, and a sufficient number of people who can operate technically in foreign languages (for cross-border supervision).

- Effective since the early 1990s, public banks and WSE-listed banks have been required to produce IAS statements with the help of *external auditors*. Because the regulatory framework was so weak in Poland in the early 1990s, the large international accounting firms were brought in to assess the magnitude of nonperforming loans and general losses of the Polish banks by international norms. As elsewhere, these audits generated results that differed markedly from the statements produced by local standards, and prompted the restructuring and recapitalization of the banks. Today, most of Poland's banks are audited by major international accounting firms. Thus, about 90 percent of the banking system's assets are subject to external audit in accordance with international standards.

4.7 Transparency and Disclosure

Poland adopted legislation in 1997 that defines the guidelines under which banks need to provide information to regulatory authorities. Poland's largest banks have been subject to increasing levels of scrutiny based on high levels of disclosure. Disclosure became increasingly public for banks as they were put on the privatization track. In particular, for banks listed on WSE—about 28 percent of WSE's capitalization derives from 16 banks—information disclosure has had to meet international standards to conform to market requirements, and later to succeed in attracting strategic investment.

There have been shortcomings over the years with BGZ and PKO BP, although this might soon change with PKO BP's planned privatization next year. In terms of companies and households, there is less transparency and disclosure, which undermines the effectiveness of banks to share information with each other for improved credit risk assessments. The new credit information bureau developed in conjunction with the Polish Banking Association may change this to some degree as banks push more deeply into retail markets, as debit and credit cards and point-of-sales terminals are increasingly utilized, as consumer lending increases, and as factoring,

leasing, and commercial credit companies start to emerge. However, the need for market-based systems is still abundant. Concerns about confidentiality abound, partly the result of pre-transition constraints on freedom and partly to evade the fiscal authorities. While these reactions are understandable, such absence of transparency makes it more difficult for Poland to develop effective credit information systems for better banking (and for credit rating agencies in support of capital markets development). As banks and others expand into retail services and securitized markets, disclosure and transparency will also need to increase to further develop these markets. This will eventually need to apply to the housing market as well. These kinds of institutional developments can be expected to lead to "market-regulated" information requirements. By then, it is also anticipated that companies and households will be willing to endure some loss of confidentiality in exchange for greater access to financial resources. This may already be happening now, as listings on the free and parallel market increase, and as consumers are benefiting from banks' increased lending and services in this area since 1996. **Score: 3**
• From the monetary perspective, the Monetary Policy Council of NBP has identified the importance of a *public information policy* as an important building block in managing expectations in pursuit of its inflation targets. The policy is expected to stress the determination and focus of MPC in bringing down the inflation rate and achieving price stabilization. Public information is expected to address long-term targets, the implementation of the monetary program to achieve those targets, and a broader discussion of Poland's economy. Through an active information dissemination campaign, MPC hopes to reduce inflationary expectations. Such an approach is new in comparison with NBP operations earlier in the 1990s.
• Most banks and companies trading in the capital markets are required to observe IAS in the preparation of statements they disclose to the public, and stricter requirements for regulators. Poland's largest banks have produced *consolidated statements* for several years, and accounted openly for *loan loss provisions* and *nonperforming loans*. As the inflation rate has come down over the years, the *revaluation* of assets has not been a major issue since 1995. Tax incentives have been operative since 1994 for banks to adequately provision for loan losses. Pre-tax profits are reported *after* provisions, thus most loan loss provisions are expensed. The regulatory framework for universal banking treats exposures and risks on a consolidated basis, and this is expected to account for *unincorporated affiliates* as well. However, there have been problems in reporting on affiliates. GINB has not been given a full mandate to supervise affiliates as well, thereby weakening some of the information flows that have been presented for regulatory purposes. As shown by Bank Staropolski, the Commission for Banking Supervision will need to improve its capacity to monitor for this with other regulatory bodies to protect against risk. In banking, it would be prudent to strengthen GINB's supervisory mandate to include the right to supervise affiliates as well in the determination of institutional risks. Tougher audit and accounting standards are also needed in financial services, as demonstrated in Polisa's statements. Banks' financial reporting conforms to regulations that are consistent with EU guidelines. However, Poland should consider strengthening these to exceed EU requirements so as to be consistent with the principles and needs of consolidated supervision. *Mark-to-market* accounting is applied for securities investments for their own portfolio management purposes, as well as for prudential regulatory

purposes.

- Legislation adopted in 1997 spells out guidelines regarding banking secrecy. These limitations generally apply to other banks on a transactions basis, the banking group for consolidation purposes, the Commission for Banking Supervision, legal and fiscal authorities, other regulatory and government authorities, and external auditors contractually appointed to audit the bank's accounts. IAS ensures a certain level of *public disclosure*, but there are still questions about the level of disclosure provided by some banks. The effectiveness of GINB/NBP and the success of listed banks has provided incentives to increase public disclosure. That international accounting firms conduct external audits on all the major Polish banks adds to the integrity of information presented, as does the presence of numerous investment houses and funds in Poland. However, the level and quality of smaller banks may sometimes be suspect. In this regard, smaller Polish accounting firms are generally limited in their training and expertise in IAS and ISA. Meanwhile, some banks have not complied with reporting requirements on a consolidated basis, or have manipulated the information to get around regulatory requirements or to distort results. Frequently, this has to do with affiliate transactions, or third party transactions. Poland has made an effort to move towards more open disclosure since it joined the OECD, as it moves towards EU accession, and as it recognizes that market development and expansion require more open disclosure of reliable and useful information. Findings from *examinations, inspections*, and regular reports to GINB are not disclosed to the public, although reports on groups of banks and the banking system are presented by NBP/GINB in its summary evaluation of the banks on a quarterly basis. These are available on the internet as well, including financial figures dating back to 1993. If there are regulatory violations, it is unclear to the public if *enforcement actions* have been taken, and if they have been consistently applied. GINB has a legal basis to enforce its mandate in cases of non-compliance, although its actions are subject to strict and cumbersome administrative requirements that are legally imposed and weaken GINB's ability to intervene swiftly when needed. What has been called in to question is whether GINB has a mandate to effectively supervise troubled banks in general, and large public banks in particular.

4.8 Sensitivity to Market Risk

Poland does not currently appear to be overly sensitive to "contagion" risks. Poland's banks and markets have withstood the crisis in Asia, weakness in Russia, and the withdrawal of investment from emerging markets. To date, Poland has come through this period with its banks and markets generally in place, with significant foreign direct investment, continued portfolio investment, and continued high levels of real GDP. Its performance is laudable, notwithstanding continued challenges that exist with regard to the inflation rate, fiscal balances, the current account deficit, rising unemployment, and difficulties in the agricultural and industrial sectors.

Now that Poland has liberalized the capital account and moved to a free floating exchange rate, higher levels of volatility in exchange rates and asset values seem inevitable. Maintaining high levels of foreign exchange reserves will continue to serve as a buffer from a macroeconomic standpoint, and this is projected to continue for the next two or three years as Poland still has many companies to privatize. At the firm-specific level, increased use of hedges against various market risks will be needed to protect against dangerous losses. From a broader perspective, there are continued risks regarding fiscal balances with elections coming up, and any reversal of what looks like a stronger period of growth in the Euro zone would weaken Poland's export prospects.

There are also macroeconomic risks regarding inflation and interest rates. The market has already begun to discount the likelihood of MPC achieving its inflation targets for the second consecutive year, and discussion by MPC of an increasingly wider tolerance band to be established in the coming years to better mitigate the impact of potential shocks may weaken discipline in this regard. The proposed increase in the tolerance band from 0.5 to 1.4 within one year raises questions about how this will be perceived in the business community, particularly if inflation targets are again not met. On the other hand, international announcements regarding oil prices may eventually ease pressure on commodity prices[238], one of the contributing factors to higher inflation rates in Poland since 3Q 1999.

One of the most persistent problems Poland faces is its current account deficit, which has steadily widened since 1996-97 and appears less affected by higher interest rates. Preliminary figures in the early months of 2000 show sustained deficits notwithstanding a 450 basis point increase in interest rates since November. While there is evidence from 2Q 2000 that banks are slowing down some of their consumer lending, current account deficits continue to mount.

At the banking level, there are many risks that could lead to stress in this sector. These include (i) fundamental credit risk—consumer lending and third party exposures (e.g., syndications, acceptance of company paper, overvalued collateral, tax fraud), (ii) exchange rate risk—particularly with a free float, and reports of unhedged positions, (iii) possible mismatches in the term structure of portfolios—use of term deposits to finance short-term loans, (iv) possible mismatches in the currency composition of portfolios—use of foreign currency-denominated borrowings to finance short-term loans in zloty, (v) insufficient gap or duration analysis conducted by some banks to measure for sensitivities (e.g., interest rate, exchange rate, fixed-variable pricing) on weighted and time-to-maturity bases, and (vi) the need to conduct stress tests combining interest rate, exchange rate, concentration and maturity assumptions to better manage risks as portfolios grow in complexity. These fundamental risks were in play in 1997-98, and Poland's results have been fairly sound. However, the banking sector did endure weak earnings in 1998-99, and the potential for bigger losses resulting from foreign exchange and asset valuation shifts is there now.

It is unclear to what extent banks engage in stress testing of portfolios, contingency planning for shocks, or other kinds of risk management practices. The large foreign banks are acknowledged to have strong systems. However, GINB concerns about internal controls and audit at many of the smaller Polish banks suggests these banks are vulnerable unless they manage their resources carefully. The collapse of Bank Staropolski was costly to the private banking sector, even though Staropolski was not a large bank. Thus, banks themselves will need to play more of a policing role to shore up the market as a whole. On this front, better communication between market players and GINB may be needed to avert a recurrence.

Future risks will emerge with increasing competition at the retail banking level—mainly from the increasing use of credit cards—as well as rising interest in loan syndications, securitization with a range of features, and mortgage lending. As elsewhere around the globe,

[238] OPEC made announcements of planned output increases in the first half of 2000. However, by 3Q 2000, prices were still high and inventories in short supply. Part of this was due to high levels of consumption in western markets, depleting inventories and pushing up spot prices. The increase was a contributing factor to the interest rate increase approved by the European Central Bank in August 2000. Should the trend continue through 3Q-4Q 2000, this will worsen Poland's inflation prospects.

internet banking will present opportunities as well as risks. However, for now, capital appears adequate, asset quality appears stable, management and governance have improved, and the general operating environment is increasingly competitive. New management systems have been put in place to advance the market, and to protect against risks. Weaknesses are in earnings and the still limited funding base of the banking system. Macroeconomic prospects are still based on high real growth, with favorable prospects for increased trade in the Euro-based markets. However, inflation, structural and fiscal weaknesses persist, as do high current account deficits, and these all increase the likelihood that interest rates (and associated risks regarding loan default and rising portfolio problems) will remain high for the coming months. **Score: 3**

- As Poland becomes increasingly integrated into the global economy, it will be subject to risks and disturbances as are other economies. *The ability to establish and sustain a competitive economy at the structural level, and the links to monetary policy* represent issues of concern in the medium term. Poland's obligations under membership agreements in the WTO and OECD require the free exchange of goods, services and capital after 2000. Thus, there is a risk that Poland's economy and banking sector may be vulnerable to dislocations. Monetary policy is expected to emphasize the need for high stocks of foreign exchange reserves to cushion shocks, stabilize the currency, and prevent a falling exchange rate from driving up inflation rates. Nevertheless, defending the currency is not the primary function of Polish monetary policy. Thus, if it occurs, NBP intervention in foreign exchange markets would be driven by inflation targeting motives rather than exchange rate motives. The move to free float puts the onus on banks and enterprises to cover these risks through prudent portfolio management and hedging as needed. At the structural level, a competitive economy able to generate significant export earnings is far more likely to provide the needed build-up of foreign exchange reserves under a stable low-inflation regime. The alternatives—either official borrowings or portfolio inflows—are likely to complicate Poland's efforts to move closer to EU/EMU and/or subject the economy to heightened sensitivity to short-term portfolio swings.

- *Portfolio inflows* may increase over time if the market perceives the zloty to be undervalued, particularly with the inflation-targeted focus of MPC. As evidence of this, Poland received the highest level ever of portfolio inflows in March 2000 after the second rate hike was announced in late February, as much of the current account deficit and rise in inflation rates relates to services inflation linked to the consumer goods sector financed with bank loans. In the future, portfolio money may be attracted based on larger funds' needs to add currencies to portfolios for diversification purposes. With the introduction of the Euro in the coming years, the number of European currencies will decline, adding to the search for additional currencies. Given the short-term nature of many portfolio investments, this will keep monetary policy and the Polish economy sensitive to market swings.

- *Credit risk* will be a clear challenge in the coming years. Most banks were prudent and risk-averse from 1993-96 as they recapitalized, readied themselves for privatization, and simply benefited from the high net spreads available to them on a relatively risk-free basis. However, the market is now more competitive. The corporate sector is saturated, and net interest margins have generally come down in recent years. Moreover, earnings were weak in 1998-99. Many banks are relatively small, namely 23 private Polish banks with less than PLN 40 million in assets on average. This may lead banks to shift risk tolerances, which will prompt the need for strengthened risk management practices. This will require testing and refining

	underwriting standards, structuring appropriate loan covenants as market conditions change, actively monitoring borrower compliance with covenants, and promptly identifying and containing risks to portfolio quality to avoid costly losses. Banks still often make a significant proportion of their loans on a "character" basis, although lending has become much more commercially oriented in recent years as government has signaled it will not finance new losses based on old lending practices. What is unknown is the degree to which high levels of real economic growth since 1994 are masking company/portfolio/transactional creditworthiness, and the degree to which these would decline if the economy were to become less buoyant. Corporate profits have declined significantly in the last two years, pointing to fairly widespread weaknesses in light of high levels of FDI and nearly 5 percent real growth. On the positive side, strict provisioning requirements on loans to the consumer lending market appear to position banks to protect their asset base from losses in this sector should they materialize.
•	Poland's *bank earnings* decreased in 1997 on a dollar basis, were anemic in 1998, and increased in 1999 to about 60 percent of 1996-97 levels. In general, earnings have been weak in both the banking and the corporate sectors since 1998. As margins tighten and cost ratios remain high, banks will be under increasing pressure to increase earnings. Lending activity will need to increase to accomplish this objective. Polish banks have shown a more than four-year willingness to increase consumer/installment financing to diversify their credit portfolios, particularly as the market for blue-chip customers has become saturated. The push into retail banking is focused on the need to build a broader funding base, and to provide services to the consumer market which frequently generates high rates of return if properly managed.
•	Poland's banks are liquid by regulatory standards. About 62 percent of total liabilities and capital are in the form of deposits, which reflects more the absence of well developed capital markets than a high level of deposits. Consequently, banks supplement these resources from the syndicated loan market. *Liquidity risk* is likely to diminish as the pool of available funding increases. However, this will be subject to the strategies in place at banks, and their ability to manage such strategies. In the near term, improved technologies[239] are contributing to liquidity management tools, but macroeconomic issues have become slightly more volatile from a liquidity management standpoint[240]. In particular, banks will need to prudently manage their liquidity facing more volatile exchange rate conditions and stubborn inflation.
•	In addition to increased and riskier lending to increase net interest margins, there is a risk that Polish banks will enter financial services that they are ill-equipped to manage, or that are costly to operate. Difficulties at some institutions in cross-selling banking and insurance products represent an example, given differing areas of specialization and expertise. During a period when earnings are strained, it is inevitable that Polish banks will add to their array of

[239] Advancements in the payment and clearing system have accelerated processing, reduced clearing and settlement time, and provided banks with better information by which to estimate their net funds position.

[240] Poland is in the process of reducing corporate tax rates on a phased basis. Privatization revenues will continue to provide extraordinary sources of financing, and FDI is projected to be strong again. The inflation rate is the problem, as this portends higher interest rates and may lead to a tightening of reserve requirements to curtail lending to the consumer sector.

services to increase and diversify income sources. Nearly half of all bank income in 1999 derived from non-interest sources[241], indicating that banks are trading in foreign exchange, and generating commissions and fees from other activities. Some are safe, but some pose risks. Rising fee income should show in higher ROA and ROE. However, while these improved in 1999, they were still lower than 1996-97 figures. Additional risk-taking in pursuit of higher earnings may lead to pricing, maturity and currency mismatches that are imprudent and could lead to periodic losses. It is not uncommon for investment-grade institutions in OECD markets to report losses, sometimes significant, in trading activities, on derivatives contracts, and from other risky exposures. Thus, losses can also be expected at Polish banks. Risk management practices will need to ensure that the banks have adequate capital and liquidity to cover such risks. Bank management, the market, and the Commission for Banking Supervision will need to closely monitor investments in instruments with financial structures that are exposed to significant *volatility in interest rates, exchange rates, and pricing.* A rise in off-balance sheet liabilities has been reported in recent years, with most of it considered risk-free or prudent hedging mechanisms against exchange rate or interest rate volatility. However, this presents an example of potential risk to the banks and NBP. If banks have excess exposure in dollars, Euro or individual European currencies at a time when exchange rates or interest rates turn, such changes could adversely impact earnings trends and asset values. It is not fully clear if there is excess exposure on a foreign exchange basis due to borrowings from abroad that are re-lent in zloty. Major open positions are not allowed at the banks, yet much of the data is converted to zloty before it reaches NBP. Bankers, investors and regulators should continue to monitor the denomination, trends, terms and conditions of funds sources to which the banks are obligated. Bankers, investors and regulators should also be mindful of and monitor the risks associated with fixed-variable interest rate or exchange rate formulas as they apply to single or multi-currency investment options. This also includes instruments that carry pricing risk—linked to commodities or other instruments. The risk of abrupt changes in these markets needs to be fully acknowledged in advance of taking positions in these instruments. Banks and companies are thought to routinely hedge their foreign currency and pricing risks to avoid high transactions costs, although many companies in the past have avoided this due to high transactions costs. However such open positions in the real sector could jeopardize bank portfolios. This needs to be monitored on an ongoing basis. One change that could be made to assist with off-site surveillance of the banking system is to include pricing data on loans and deposits in bank reporting forms to NBP. Currently, repricing on variable rate instruments is apparently absent.

- *Risk management* practices are generally considered satisfactory, although it is not clear if banks are all fully prepared to manage exchange rate risks in a freely floating regime, or if MIS provides management with what is needed for continued and effective monitoring of portfolio risks. Earlier issues raised in the 1998 report included questions about whether current reporting forms provide sufficient information on the volume and types of transactions in foreign currency. At a minimum, GINB/NBP will need to monitor syndicated lending patterns and the denomination of the source of funds for which the banks are obligated. The onus will be on the banks to properly manage these exposures. However, the risk to a stable monetary policy is that a large bank or banks would fail to do so, suggesting that the MPC should also obtain more precise information on the types and volume of transactions taking place, particularly as banks are likely to show more derivatives in their activities and

241 This is up from about one quarter in 1997.

	portfolios. Banks are thought to routinely hedge their foreign currency risk, but there may be risk in the corporate sector, where losses could jeopardize company cash flow and put loan service/repayment to banks at risk. However, it is inevitable over time that Polish banks will take on increasing exposure to instruments that may present significant risk. With the average Polish bank having $113 million in capital, one or two significant losses relative to exposure could undermine a bank's solvency and challenge its liquidity. The NBP/GINB will need to identify these possibilities early on to prevent systemic consequences. With the shift to a freely floating exchange rate, NBP is mindful that financial institutions and businesses will be exposed to greater exchange rate risk. Thus, it will be incumbent on firms across the board to strengthen their liquidity and exchange rate management capacity. This will require development of sound information systems, prudent management, and appropriate oversight from boards and, where necessary, regulators. NBP and the MPC intend to be open about exchange rate policy directions to better inform the public, and to make it more feasible for businesses to adapt to changes in policy. This is also expected to lead to development of hedging mechanisms in the marketplace, which should lead to increased fee income for banks and more sophisticated treasury operations for companies.
•	Movement towards universal banking is expected to increase activity for the banking sector given their brokerages, ownership stakes in insurance companies, and expected activity in mortgage financing and leasing. As the markets broaden and deepen, risks will likewise proliferate. In particular, the risks associated with securitization will increase, as will exotic features attached to differing instruments to fill portfolio niches. Now that new legislation provides banks with more of an opportunity to enter non-bank activities, they will have to apply proper *management principles* to prevent systemic or highly damaging risks from materializing. Above all, up-to-date *information systems*, effective and accountable *management structures*, well-coordinated *risk management procedures*, and substantial capital and reserves for unforeseen risks will be needed.
•	As in any banking sector, there are ripple effects in the event that individual banks are imprudent in the management of resources. This is an issue of considerable importance for PKO BP and Pekao SA, given their share of deposits. Banks will need to continue to prudently manage resources to be able to honor *transactions*, a challenge that will become increasingly demanding as competition increases and margins narrow. Banks will need to maintain strong internal controls, high levels of accountability, and effective governance and management. GINB has noted the erratic performance of internal controls across the banking sector. Banks will need to be in *compliance* with contractual agreements, which also is tied to transaction risk. Compliance with prudential regulations, and public disclosure of such compliance, sends a signal that banks appear safe and sound. The absence of compliance again undermines confidence, and reduces efficiency. Where high levels of forbearance are provided on an ongoing basis, as has occurred through BGF in recent years, this can also weaken confidence. However, to be fair, the financial condition of PKO BP and BGZ appear to be stronger today than two years ago, adding to confidence in the system. This is reflected in continued deposit mobilization by PKO BP. Regulatory compliance backed by a well functioning legal framework will be needed to manage compliance risk. Poland is still working to develop its judicial capacity, to strengthen banks' internal audit functions, and to extend the full banking supervision mandate to all banks. Movement towards extending this mandate on a consolidated basis will be needed to ensure effective supervision can be sustained. Deposit

insurance is meant to provide confidence to depositors, and the Bank Guarantee Fund is meant to provide resources prior to the need for lender-of-last-resort financing. However, in the case of the latter, there are significant questions about how prudent this policy is, or how prudent the administration of this policy has been given the costly transfer to deeply insolvent institutions. More recently, the formula for assessments on banks when failures exceed available resources has been called into question. Capacity to monitor for compliance should also be a consideration with regard to overall *strategic* risk. Poland's banks have strengthened governance and management after several years of restructuring, yet there are still questions about the adequacy of information systems and their use for risk management purposes, and the capacity of staff at the public banks and some of the smaller private banks. There are also questions about the suitability of some of the people serving on supervisory and management boards, although this has improved in recent years as professionalization, competition and foreign investment have proceeded to modernize the sector. Finally, competitiveness of individual institutions and the market as a whole will need to increase to enhance the existing *reputation* of Poland's banking sector. This has improved over the years, and increased investment from prime-rated institutions has added legitimacy to the market. The real test will be risk management capacity as growth unfolds, risks increase, and globalization accelerates.

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